



# **INCOME TAX REGULATIONS**

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**Under the Internal Revenue Code of 1954**

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### ***NOTE***

The regulatory provisions appearing in this pamphlet are a compilation of all portions of the Income Tax Regulations issued under the Internal Revenue Code of 1954 during the period January 1, 1957 through December 31, 1957. These provisions were published in daily issues of the Federal Register in compliance with the Administrative Procedure Act (5 USC 1001) and were later reprinted in the weekly issues of the Internal Revenue Bulletin. A limited number of these pamphlets have been prepared for use until complete Income Tax Regulations under Part 1, Title 26 (1954), Code of Federal Regulations are available in book form. Previously issued pamphlets in this series contained Income Tax Regulations issued under the 1954 Code during the following periods: Publication No. 329-1, period August 17, 1954 through May 31, 1956; Publication No. 329-2, period June 1, 1956 through December 31, 1956.



## EXPLANATION OF APPLICABILITY AND ARRANGEMENT OF INCOME TAX REGULATIONS

**SCOPE**—The regulations relating to the income taxes imposed by the Internal Revenue Code of 1954 have been designated Income Tax Regulations (26 CFR Part 1). These regulations relate to subtitle A (chs. 1–6, incl.) and certain related administrative provisions of subtitle F of the 1954 Code. The practice of assigning a separate Internal Revenue Service number to new regulations (such as Regulations 111 or Regulations 118) has been discontinued.

**APPLICABILITY**—Income Tax Regulations (26 CFR Part 1) generally are applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954. However, in those instances where the applicability of the provision of law is stated in terms of a specific date occurring after December 31, 1953, or in terms of taxable years ending after a specific date occurring after December 31, 1953, these regulations may also relate to the income taxes imposed by the Internal Revenue Code of 1939. Two other principal exceptions to this rule are the regulations under chapters 3 and 5 of the 1954 Code, which are applicable to payments and transfers occurring after December 31, 1954.

**ARRANGEMENT AND NUMBERING**—The Income Tax Regulations are subject to codification in the Code of Federal Regulations and are published as Part 1, Subchapter A, Chapter I, Title 26 (1954) of that Code. As a document subject to codification, the arrangement and numbering conform to the rules prescribed by the Administrative Committee of the Federal Register in Part 1, Chapter I, Title 1 of the Code of Federal Regulations.

Each section of the regulations is preceded by the section, subsection or paragraph of the Internal Revenue Code of 1954 which it interprets. The sections of the regulations can readily be distinguished from sections of the Code since—

1. The sections of the regulations are printed in larger type;
2. The sections of the regulations are preceded by a section symbol and the part number, arabic numeral 1, followed by a decimal point (§ 1.) and;
3. The sections of the Code are preceded by “Sec.”.

Each section of the regulations setting forth law or regulations is designated by a number composed of the part number followed by a decimal point (1.) and the number of the corresponding provision of the Internal Revenue Code of 1954. In the case of a section setting forth regulations, this designation is followed by a dash (—) and a number identifying such a section. By use of these designations one can ascertain the sections of the regulations relating to a provision of the Code. Thus, the section of the regulations setting forth

section 301 of the 1954 Code is designated § 1.301, and the regulations pertaining to such section 301 is designated § 1.301-1.

In some cases the regulations are broken down in such manner as to relate to a single subsection of a section rather than to the section as a whole. Thus, the regulations under section 108 are broken down so that those under section 108(a) are designated as § 1.108(a)-1 and § 1.108(a)-2 and those under section 108(b) are designated as § 1.108(b)-1. Generally, however, the regulations will not be broken down in such manner as to indicate, by specific designation, that they relate to any division of law inferior to a subsection. Thus, for example, the section of the regulations which contains regulations under section 108(a)(2) of the Internal Revenue Code of 1954 is designated § 1.108(a)-2 rather than § 1.108(a)(2)-1.

In some cases several sections of the regulations relate to a single section or subsection of the Internal Revenue Code of 1954. For example, §§ 1.105-1 to 1.105-5, inclusive, all deal with section 105 of the Code. Similarly, both § 1.108(a)-1 and § 1.108(a)-2 deal with section 108(a) of the Code.

Regulations under certain revenue laws not included in the Internal Revenue Code of 1954 depart from the numbering described in the preceding paragraphs. See, for example, the regulations issued under Public Law 74, Eighty-fourth Congress (§§ 1.9000-1 to 1.9000-8, incl.).

As an additional convenience to the reader, a partial comparison of the system of numbering the various divisions of the Code of Federal Regulations and the Internal Revenue Code of 1954 is set forth below:

<i>Code of Federal Regulations</i>			<i>Internal Revenue Code of 1954</i>	
<i>Division</i>	<i>Description of Number</i>	<i>Example</i>	<i>Description of Number</i>	<i>Example</i>
Section.....	Arabic numeral separated from the part number by a decimal:		Arabic numeral ....	31
	Section setting forth law ....	1.31		
	Section setting forth regulations .....	1.31-1		
Subsection.....	(None) .....	.....	Small letter in parentheses	(a)
*Paragraph.....	Small letter in parentheses	(a)	Arabic numeral in parentheses	(1)
Subparagraph....	Arabic numeral in parentheses	(1)	Capital letter in parentheses	(A)
Subdivision.....	Small roman numeral in parentheses	(i)	Small roman numeral in parentheses	(i)
Inferior subdivisions.....	Small italic letter in parentheses	(a)	None	

[\*It should be noted that the first internal division of a regulations section is "paragraph" and the first internal division of a law section is "subsection."]

MEANING OF TERMS—References to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954 unless otherwise indicated.

The term “the regulations in this part” when used in these regulations means the regulations in Part 1, Subchapter A, Chapter I, Title 26 (1954), of the Code of Federal Regulations, that is, the Income Tax Regulations (26 CFR Part 1).

TABLE OF CONTENTS—There is shown preceding the text of the regulations a table of the sections containing statutory or regulatory provisions which appear in this publication.

INDEX—An index to the material contained in this publication follows the text of the regulatory material.

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- §§ 1.6654 through 1.6655-3, T.D. 6267, 22 F.R. 9059, Nov. 14, 1957; I.R.B. 1957-47, 66.]

## TEMPORARY RULES RELATING TO THE INCOME TAX AND ADMINISTRATIVE MATTERS UNDER THE INTERNAL REVENUE CODE OF 1954

The temporary rules, prescribed by Treasury Decisions 6118, 6124, 6131, 6208, and 6209, relating to certain elections or other actions by taxpayers under provisions of the Internal Revenue Code of 1954 which do not correspond to provisions of the Internal Revenue Code of 1939, and published in previously issued pamphlets in this series (Publication No. 329-1, page 17 and Publication 329-2, page 21) have been superseded in part by permanent regulations as indicated below. Such supersedures are in addition to those noted in the previous pamphlets.

### PARAGRAPH 5. RESEARCH AND EXPERIMENTAL EXPENDITURES.

[Superseded by permanent regulations—T.D. 6255, 22 F.R. 7901, October 4, 1957; I.R.B. 1957-42, 21.]

### PAR. 6. SOIL AND WATER CONSERVATION EXPENDITURES TREATED AS EXPENSES NOT CHARGEABLE TO CAPITAL ACCOUNT.

[Superseded by permanent regulations—T.D. 6235, 22 F.R. 3849, June 1, 1957; I.R.B. 1957-24, 7.]

### PAR. 9. ACCRUAL OF REAL PROPERTY TAXES.

[Superseded by permanent regulations—T.D. 6282, 22 F.R. 10686, December 25, 1957; I.R.B. 1958-1, 25.]

### PAR. 16. SPECIAL RULES APPLICABLE TO DISTRIBUTIONS BY TRUSTS IN FIRST 65 DAYS OF TAXABLE YEAR.

[Superseded by permanent regulations—T.D. 6217, 21 F.R. 10207, December 20, 1956; C.B. 1956-2, 336, Publication 329-2.]

### PAR. 17. FOREIGN TAX CREDIT ALLOWED TO SHAREHOLDERS OF A REGULATED INVESTMENT COMPANY; MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.

[Superseded by permanent regulations—T.D. 6236, 22 F.R. 3872, June 4, 1957; I.R.B. 1957-24, 19.]



# INCOME TAX REGULATIONS

## INCOME TAXES

### NORMAL TAXES AND SURTAXES

#### DETERMINATION OF TAX LIABILITY

##### TAX ON CORPORATIONS

### § 1.11 STATUTORY PROVISIONS; TAX ON CORPORATIONS.

[In § 1.11, section 11 (b) and the historical note at the end of section 11 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 65) was deleted by T.D. 6237 and the following provisions and statements inserted in lieu thereof.]

#### SEC. 11. TAX IMPOSED. \* \* \*

##### (b) NORMAL TAX.—

(1) TAXABLE YEARS BEGINNING BEFORE JULY 1, 1958.—In the case of a taxable year beginning before July 1, 1958, the normal tax is equal to 30 percent of the taxable income.

(2) TAXABLE YEARS BEGINNING AFTER JUNE 30, 1958.—In the case of a taxable year beginning after June 30, 1958, the normal tax is equal to 25 percent of the taxable income.

\* \* \* \* \*

[Sec. 11 as amended by sec. 2, Tax Rate Extension Act, 1955; sec. 2, Tax Rate Extension Act, 1956; sec. 2, Tax Rate Extension Act, 1957.]

### § 1.11-1 TAX ON CORPORATIONS. \* \* \*

[Paragraph (c) of § 1.11-1 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 66) was deleted by T.D. 6237 and the following provisions inserted in lieu thereof.]

(c) The normal tax is computed by applying to the taxable income the rate of tax in effect for the taxable year. The rates of tax applicable for the respective taxable years are as follows:

	<i>Percent</i>
For taxable years beginning before July 1, 1958.....	30
For taxable years beginning after June 30, 1958.....	25

#### CHANGES IN RATES DURING A TAXABLE YEAR

### § 1.21-1 CHANGES IN RATE DURING A TAXABLE YEAR.—

[In § 1.21-1, paragraph (a) and example (2) of § 1.21-1(n) as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 68 and 73) were deleted and the following provisions inserted in lieu thereof.]

(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter 1 upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. Thus, for example, the normal tax on corporations is, under section 11(b), decreased from 30 percent to 25 percent in the case of a taxable year beginning after June 30, 1958. Accordingly, the tax for a taxable year of a corporation beginning on July 1, 1958, will be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before July 1, 1958, and ending on or after that



date, the tax will be computed under section 21. For additional circumstances under which section 21 is not applicable, see paragraph (k) of this section.

\* \* \* \* \*

(n) The application of section 21 may be illustrated by the following examples:

\* \* \* \* \*

*Example (2).* For purposes of this example, the following facts are assumed: The taxpayer is a corporation, its taxable year is the calendar year 1958, its taxable income for both normal tax and surtax purposes is \$100,000, and it is subject to a change in the rate of the normal tax from 30 percent of taxable income to 25 percent of taxable income effective on July 1, 1958. The change in the normal tax rate applicable to the corporation does not affect the amount of any other tax applicable to the corporation under chapter 1. In such case, the tentative tax at the 30 percent rate would be \$30,000, and the tentative tax at the 25 percent rate would be \$25,000. The proportionate part of the tentative tax at the 30 percent rate is \$14,876.71, that is, an amount which is the same proportion of \$30,000 as 181 (the number of days from January 1 to June 30, 1958, both dates inclusive) is to 365 (the total number of days in the taxable year). The proportionate part of the tentative tax at the 25 percent rate is \$12,602.74, that is an amount which is the same proportion of \$25,000 as 184 (the number of days from July 1 to December 31, 1958, both dates inclusive) is to 365.

#### CREDITS AGAINST TAX

### § 1.37 STATUTORY PROVISIONS; RETIREMENT INCOME.

[In § 1.37, section 37(d)(2) and the historical note at the end of section 37 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 83) were deleted by T.D. 6237 and the following provisions and statements inserted in lieu thereof.]

#### SEC. 37. RETIREMENT INCOME \* \* \*

##### (d) LIMITATION ON RETIREMENT INCOME. \* \* \*

(2) in the case of any individual who has not attained the age of 72 before the close of the taxable year, any amount of earned income (as defined in subsection (g))—

(A) in excess of \$900 received by the individual in the taxable year if such individual has not attained the age of 65 before the close of the taxable year, or

(B) in excess of \$1,200 received by the individual in the taxable year if such individual has attained the age of 65 before the close of the taxable year.

\* \* \* \* \*

[Sec. 37 as amended by Pub. Law 299 (84th Cong.), for taxable years beginning after December 31, 1954, and by Pub. Law 398 (84th Cong.), for taxable years beginning after December 31, 1955. For taxable years beginning before January 1, 1955, sec. 37 (f) contains “; except that such term does not include a fund or system established by the United States for members of the Armed Forces of the United States” after the words “District of Columbia”. For taxable years beginning before January 1, 1956, sec. 37 (d) (2) provides: “(2) in the case of any individual who has not attained the age of 75 before the close of the taxable year, any amount of earned income (as defined in subsection (g)) in excess of \$900 received by the individual in the taxable year.”]

### § 1.37-4 LIMITATION ON AMOUNT OF RETIREMENT INCOME.—

[Section 1.37-4 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 89) was deleted by T.D. 6237 and the following provisions were inserted in lieu thereof.]

#### § 1.21-1(n)

(a) Section 37(d) provides a limitation on the amount of retirement income with respect to which the retirement income credit is allowable. Such credit is computed on the amount of retirement income, as defined in section 37(c), but on not more than the amount determined as the limitation provided by section 37(d). In any event, the maximum amount of retirement income with respect to which the retirement income credit is allowable is \$1,200.

(b) The limitation provided by section 37(d) is determined by subtracting from \$1,200 the sum of—

(1) Amounts received during the taxable year as (i) a pension or annuity under Title II of the Social Security Act; (ii) a pension or annuity under the Railroad Retirement Acts of 1935 or 1937; (iii) any other pension or annuity which is excludable from gross income, such as pensions received under laws relating to veterans; and

(2) (i) For taxable years beginning after December 31, 1955, the amount of earned income received during the taxable year in excess of (a) \$900, if the individual has not attained the age of 65 before the close of his taxable year, or (b) \$1,200, if the individual has attained the age of 65 but not 72 before the close of his taxable year; or

(ii) For taxable years beginning before January 1, 1956, the amount of earned income received during the taxable year in excess of \$900, if the individual has not attained the age of 75 before the close of his taxable year.

(c) In determining the limitation of section 37(d), the following additional rules shall be applicable:

(1) No reduction shall be made on account of any amounts excluded from gross income because of the application of section 72 (relating to annuities), section 101 (relating to life insurance proceeds), section 104 (relating to compensation for injuries or sickness), section 105 (relating to amounts received under accident and health plans), section 402 (relating to taxability of beneficiary of employees' trust), or section 403 (relating to taxation of employees annuities).

(2) For taxable years beginning after December 31, 1955, no reduction for earned income received during the taxable year shall be made in the case of an individual who has attained the age of 72 before the close of his taxable year; and for taxable years beginning before January 1, 1956, no reduction for earned income received during the taxable year shall be made in the case of an individual who has attained the age of 75 before the close of his taxable year.

(3) The term "earned income" has the same meaning as in § 1.37-2(a). (However, the special rule relating to widows and widowers contained in section 37(b) is not applicable in determining the limitation of section 37(d).)

(4) Where the amounts designated in paragraph (b) of this section are treated as community income under community property laws applicable with respect to such income, such amounts shall be treated as received one-half by each spouse.

(5) In no event can the sum of the amounts designated in paragraph (b) of this section reduce the amount of the retirement income, or the credit with respect thereto, to less than zero.

(d) The determination of the limitation of section 37(d) may be illustrated by the following examples:

*Example (1).* If an individual eligible for the retirement income credit, age 68 at the close of the taxable year 1954, received as his only income during the taxable year \$800 of interest and \$1,700 as compensation for personal services rendered by him during such year, the individual is entitled for such taxable year to a retirement income credit on \$400 of the interest. Since the individual had not attained the age of 75 before the close of the taxable year, the limitation of section 37(d) is determined by subtracting from \$1,200 the amount of \$800, that is, the amount of earned income (\$1,700) which is in excess of \$900. The limitation is thus \$400 (\$1,200 less \$800) and the retirement income credit is computed on \$400 of the retirement income (the interest item). If the individual had attained the age of 75 before the close of the taxable year 1954, no amount would be subtracted from \$1,200 by reason of his earned income and the limitation would then be \$1,200 instead of \$400, and the retirement income credit would be computed on the entire amount of the interest item of \$800.

*Example (2).* Assume that the individual in example (1) received the same items of income for his 1957 taxable year. Since the individual has attained the age of 65 but not the age of 72 before the close of such taxable year, the limitation of section 37(d) is determined by subtracting from \$1,200 the amount of \$500, that is, the amount of earned income (\$1,700) which is in excess of \$1,200. The limitation is thus \$700 (\$1,200 less \$500) and the retirement income credit is computed on \$700 of the retirement income (the interest item). If the individual had attained the age of 72 before the close of the taxable year 1957, no amount would be subtracted from \$1,200 by reason of his earned income, and the limitation would then be \$1,200 instead of \$700, and the retirement income credit would be computed on the entire amount of the interest item of \$800.

#### § 1.37-5 ILLUSTRATION OF APPLICATION OF SECTION 37.—

[Section 1.37-5 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 90) was deleted by T.D. 6237 and the following provisions were inserted in lieu thereof.]

The application of section 37 may be illustrated by the following example:

*Example.* Assume that an individual eligible for the retirement income credit, 70 years of age, unmarried, computing his tax under section 3, has the following items of income for the calendar year 1956:

Dividend income (of which \$50 is excluded from gross income under section 116) .....	
Pension under the Railroad Retirement Act of 1937 (entirely excluded from gross income) .....	\$750
Disability payments under a workmen's compensation act (entirely excluded from gross income under section 104) .....	600
Rental income .....	400
Earned at odd jobs .....	600
	1,300

First, the taxpayer must compute his tax before the credit, as follows:

Adjusted gross income (\$700 dividend income + \$600 rental income + \$1,300 earned income) .....	\$2,600
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Tax before any credit (determined by table in section 3).....	230
Less dividend received credit under section 34.....	28

Tax before retirement income credit..... \$202

Next, the taxpayer must compute his retirement income credit as follows:

Retirement income includes:	
Dividend income .....	\$700
Rental income .....	600
Total retirement income .....	\$1,300

But the limitations in section 37(d) provide that this amount may not exceed a maximum amount for the taxable year 1956, determined as follows:

Maximum amount (before reduction) .....	\$1,200
Less railroad retirement pension .....	600
	\$600
Less earned income in excess of \$1,200.....	100

Amount of retirement income upon which the credit is computed.. \$500

The retirement income credit is computed by applying the 20 percent rate to the maximum amount of retirement income reduced by the railroad retirement pension and the earned income in excess of \$1,200, as follows:

Maximum amount of retirement income as reduced above.....	\$500
20 percent rate .....	.20
Retirement income credit .....	\$100

#### COMPUTATION OF TAXABLE INCOME

#### DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

### § 1.61 STATUTORY PROVISIONS; GROSS INCOME DEFINED.

#### SEC. 61. GROSS INCOME DEFINED.

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts<sup>101</sup>;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

(b) CROSS REFERENCES.—For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

§ 1.61-1 GROSS INCOME.—(a) *General definition*.—Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

(b) *Cross references*.—Cross references to other provisions of the Internal Revenue Code of 1954 are to be found throughout the regulations under section 61. The purpose of these cross references is to direct attention to the more common items which are included in or excluded from gross income entirely, or treated in some special manner. To the extent that another section of the Internal Revenue Code of 1954, or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and these regulations. The cross references do not cover all possible items.

(1) For examples of items specifically included in gross income, see sections 71 through 77.

(2) For examples of items specifically excluded from gross income, see sections 101 through 121.

(3) For general rules as to the taxable year for which an item is to be included in gross income, see section 451 and the regulations thereunder.

§ 1.61-2 COMPENSATION FOR SERVICES, INCLUDING FEES, COMMISSIONS, AND SIMILAR ITEMS.—(a) *In general*.—(1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Internal Revenue Code of 1954 provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Internal Revenue Code of 1954 provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

§ 1.61-1(a)

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 121.

(b) *Members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service.*—Subsistence and uniform allowances granted commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States, and amounts received by them as commutation of quarters, are to be excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is to be excluded from gross income. For the exclusion from gross income of—

(1) Disability pensions, see section 104(a)(4) and the regulations thereunder;

(2) Mustering-out payments, see section 113 and the regulations thereunder;

(3) Miscellaneous items, see section 121.

However, the per diem allowance in lieu of subsistence and the mileage allowance received by such persons while in a travel status or on temporary duty away from their permanent stations shall be included in their gross income.

(c) *Payment to charitable, etc., organization on behalf of person rendering services.*—The value of services is not includible in gross income when such services are rendered directly and gratuitously to an organization described in section 170(c). Where, however, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

(d) *Compensation paid other than in cash.*—(1) *In general.*—If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received, in the absence of evidence to the contrary.

(2) *Property transferred to employee; insurance premiums paid by employer.*—Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options), if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income. Generally, life insurance premiums paid by

an employer on the lives of his employees, where the proceeds of such insurance are payable to the beneficiaries of such employees, are part of the gross income of the employees. However, premiums paid by an employer on policies of group term life insurance covering the lives of his employees are not gross income to the employees, even if they designate the beneficiaries. For special rules relating to the exclusion of contributions by an employer to accident and health plans, see section 106 and the regulations thereunder.

(3) *Meals and living quarters*.—The value of living quarters or meals which an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee*.—If a corporation transfers its own stock to an employee as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

§ 1.61-3 GROSS INCOME DERIVED FROM BUSINESS.—(a) *In General*.—In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income, and without subtraction of selling expenses, losses, or other items is not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

(b) *State contracts*.—The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If, upon conversion of the warrants into cash, the contractor does not receive and cannot recover the full value of the warrants so returned, he may deduct any loss sustained from his gross income for the year in which the warrants are so converted. If, however, he realizes more than the value of the warrants so returned, he must include the excess in his gross income for the year in which realized.

§ 1.61-2(d) (3)

§ 1.61-4 GROSS INCOME OF FARMERS.—(a) *Farmers using the cash method of accounting.*—A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). However, see section 162 and the regulations thereunder with respect to the computation of taxable income on other than the crop method where the cost of seeds or young plants purchased for further development and cultivation prior to sale is involved. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(b) *Farmers using an accrual method of accounting.*—A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in subparagraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, breeding, or dairy purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the in-



ventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(c) *Special rules for certain receipts.*—In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. See, however, section 453 and the regulations thereunder for special rules relating to certain installment sales. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Proceeds of insurance, such as hail or fire insurance on growing crops, should be included in gross income to the extent of the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method; but in any such cases, the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized, and not earlier.

(d) *Definition of "farm".*—As used in this section, the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. For more detailed rules with respect to the determination of whether or not an individual is engaged in farming, see § 1.175-3. For rules applicable to persons cultivating or operating a farm for recreation or pleasure, see sections 162 and 165, and the regulations thereunder.

(e) *Cross references.*—(1) For election to include Commodity Credit Corporation loans as income, see section 77 and regulations thereunder.

(2) For definition of gross income derived from farming for purposes of limiting deductibility of soil and water conservation expenditures, see section 175 and regulations thereunder.

(3) For definition of gross income from farming in connection with

declarations of estimated income tax, see section 6073 and regulations thereunder.

§ 1.61-5 ALLOCATIONS BY COOPERATIVE ASSOCIATIONS; TAX TREATMENT AS TO PATRONS.—(a) *In general*.—Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the allocation is deemed, for the purpose of section 522, to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability*.—(1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron to the following extent:

- (i) If the allocation is in cash, in the amount of cash received.
- (ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.
- (iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates, or similar documents—

(a) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time mentioned in § 1.522-3(a) (2).

(b) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as “reasonable reserves” under § 1.522-3(a).

(c) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in (a) of this subdivision, or from amounts retained as “reasonable reserves” referred to in (b) of this subdivision. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

(2) Amounts which are allocated on a patronage basis by cooperative association with respect to supplies, equipment or so

the cost of which was not deductible by the patron under section 162 or section 212, are not includible in the computation of the gross income of such patron; however, in the case of such amounts which are allocated with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, such amounts shall, to the extent set forth in subparagraph (1) of this paragraph, be taken into account in determining the cost or other basis of the assets or property purchased for the patron. For example, if a farmer purchased a tractor in 1955 from a cooperative association for use in his farming activities for \$2,000 and in a later year (after \$100 has been properly deducted as depreciation in computing taxable income) has \$100 allocated to him on a patronage basis by reason of his purchase of the tractor, then such \$100 is not included in his gross income, but in the year of receipt reduces his unrecovered cost or other basis of the tractor, determined in accordance with section 1016, to \$1,500. All subsequent depreciation deductions shall be determined on the basis of such remaining cost and the remaining expected useful life of the tractor.

**§ 1.61-6 GAINS DERIVED FROM DEALINGS IN PROPERTY.**—(a) *In general.*—Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

*Example (1).* A, a dealer in real estate, acquires a 10-acre tract for \$10,000, which he divides into 20 lots. The \$10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

*Example (2).* B purchases for \$25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is \$15,000 and the fair market value of the used car lot is \$10,000. Five years later B sells the filling station for \$20,000 at a time when \$2,000 has been properly allowed as depreciation thereon. B's gain on the sale is \$7,000, since \$7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

(b) *Nontaxable exchanges.*—Certain realized gains or losses on the sale or exchange of property are not "recognized", that is, are not

included in or deducted from gross income at the time the transaction occurs. Gain or loss from such sales or exchanges is generally recognized at some later time. Examples of such sales or exchanges are the following:

(1) Certain formations, reorganizations, and liquidations of corporations, see sections 331, 333, 337, 351, 354, 355, and 361;

(2) Certain formations and distributions of partnerships, see sections 721 and 731;

(3) Exchange of certain property held for productive use or investment for property of like kind, see section 1031;

(4) A corporation's exchange of its stock for property, see section 1032;

(5) Certain involuntary conversions of property, if replaced, see section 1033;

(6) Sale or exchange of residence if replaced, see section 1034;

(7) Certain exchanges of insurance policies and annuity contracts, see section 1035; and

(8) Certain exchanges of stock for stock in the same corporation, see section 1036.

(c) *Character of recognized gain.*—Under subchapter P of chapter 1 of the Internal Revenue Code of 1954, relating to capital gains and losses, certain gains derived from dealings in property are treated specially, and under certain circumstances the maximum rate of tax on such gains is 25 percent, as provided in section 1201. Generally, the property subject to this treatment is a "capital asset", or treated as a "capital asset". For definition of such assets, see sections 1221 and 1231, and the regulations thereunder. For some of the rules either granting or denying this special treatment, see the following sections and the regulations thereunder:

(1) Transactions between partner and partnership, section 707;

(2) Sale or exchange of property used in the trade or business and involuntary conversions, section 1231;

(3) Payment of bonds and other evidences of indebtedness, section 1232;

(4) Gains and losses from short sales, section 1233;

(5) Options to buy or sell, section 1234;

(6) Sale or exchange of patents, section 1235;

(7) Securities sold by dealers in securities, section 1236;

(8) Real property subdivided for sale, section 1237;

(9) Amortization in excess of depreciation, section 1238;

(10) Gain from sale of certain property between spouses or between an individual and a controlled corporation, section 1239;

(11) Taxability to employee of termination payments, section 1240.

§ 1.61-7 INTEREST.—(a) *In general.*—As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held

under an agreement to pay interest thereon; and interest on refunds of Federal taxes. For rules determining the taxable year in which interest, including interest accrued or constructively received, is included in gross income, see section 451 and the regulations thereunder. For the inclusion of interest in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. For credit of tax withheld at source on interest on tax-free covenant bonds, see section 32 and the regulations thereunder.

(b) *Interest on Government obligations.*—(1) *Wholly tax-exempt interest.*—Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia, is wholly exempt from tax. Interest on certain United States obligations issued before March 1, 1941, is exempt from tax to the extent provided in the acts of Congress authorizing the various issues. See section 103 and the regulations thereunder.

(2) *Partially tax-exempt interest.*—Interest earned on certain United States obligations is partly tax exempt and partly taxable. For example, the interest on United States Treasury bonds issued before March 1, 1941, to the extent that the principal of such bonds exceeds \$5,000, is exempt from normal tax but is subject to surtax. See sections 35 and 103, and the regulations thereunder.

(3) *Fully taxable interest.*—In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable; but see section 103 and the regulations thereunder. A taxpayer using the cash receipts and disbursements method of accounting who owns United States savings bonds issued at a discount has an election as to when he will report the interest; see section 454 and the regulations thereunder.

(c) *Obligations bought at a discount; bonds bought when interest defaulted or accrued.*—When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

(d) *Bonds sold between interest dates; amounts received in excess of original issue discount; interest on life insurance.*—When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond or other evidence of indebtedness may under some circumstances constitute capital gain instead of ordinary income. See section 1232 and the regulations thereunder. Interest

payments on amounts payable as employees' death benefits (whether or not section 101(b) applies thereto) and on the proceeds of life insurance policies payable by reason of the insured's death constitute gross income under some circumstances. See section 101 and the regulations thereunder for details. Where accrued interest on unwithdrawn insurance policy dividends is credited annually and is subject to withdrawal annually by the insured, such interest credits constitute taxable income to the insured as of the year of credit.

§ 1.61-8 RENTS AND ROYALTIES.—(a) *In general*.—Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. For the inclusion of rents in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Gross income includes royalties. Royalties may be received from books, stories, plays, copyrights, trademarks, formulas, patents, and from the exploitation of natural resources, such as coal, gas, oil, copper, or timber. Payments received as a result of the transfer of patent rights may under some circumstances constitute capital gain instead of ordinary income. See section 1235 and the regulations thereunder. For special rules for certain income from natural resources, see sections 611 to 632 and the regulations thereunder.

(b) *Advance rentals; cancellation payments*.—Gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. As to amounts received by a lessee for the cancellation of a lease, see section 1241 and the regulations thereunder.

(c) *Expenditures by lessee*.—As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances. For the exclusion from gross income of income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by a lessee, see section 109 and the regulations thereunder. For the exclusion from gross income of a lessor corporation of certain of its income taxes on rental income paid by a lessee corporation under a lease entered into before January 1, 1954, see section 110 and the regulations thereunder.

§ 1.61-9 DIVIDENDS.—(a) *In general*.—Except as otherwise specifically provided, dividends are included in gross income under sections 61 and 301. For the principal rules with respect to dividends includible in gross income, see section 316 and the regulations thereunder. As to distributions made or deemed to be made by regulated investment companies, see sections 851 through 855, and the regulations there-

under. See section 116 for the exclusion from gross income of \$50 of dividends received by an individual, except those from certain corporations. Furthermore, dividends may give rise to a credit against tax under section 34, relating to dividends received by individuals, and under section 37, relating to retirement income.

(b) *Dividends in kind; stock dividends; stock redemptions.*—Gross income includes dividends in property other than cash, as well as cash dividends. For amounts to be included in gross income when distributions of property are made, see section 301 and the regulations thereunder. A distribution of stock, or rights to acquire stock, in the corporation making the distribution is not a dividend except under the circumstances described in section 305(b). However, the term “dividend” includes a distribution of stock, or rights to acquire stock, in a corporation other than the corporation making the distribution. For determining when distributions in complete liquidation shall be treated as dividends, see section 333 and the regulations thereunder. For rules determining when amounts received in exchanges under section 354 or exchanges and distributions under section 355 shall be treated as dividends, see section 356 and the regulations thereunder.

(c) *Dividends on stock sold.*—When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. In some cases, however, the purchaser may be considered to be the recipient of the dividend even though he has not received the legal title to the stock itself and does not himself receive the dividend. For example, if the seller retains the legal title to the stock as trustee solely for the purpose of securing the payment of the purchase price, with the understanding that he is to apply the dividends received from time to time in reduction of the purchase price, the dividends are considered to be income to the purchaser.

§ 1.61-10 ALIMONY AND SEPARATE MAINTENANCE PAYMENTS; ANNUITIES; INCOME FROM LIFE INSURANCE AND ENDOWMENT CONTRACTS.—(a) *In general.*—Alimony and separate maintenance payments, annuities, and income from life insurance and endowment contracts in general constitute gross income, unless excluded by law. Annuities paid by religious, charitable, and educational corporations are generally taxable to the same extent as other annuities. An annuity charged upon devised land is taxable to the donee-annuitant to the extent that it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land.

(b) *Cross references.*—For the detailed rules relating to—

(1) Alimony and separate maintenance payments, see section 71 and the regulations thereunder;

(2) Annuities, certain proceeds of endowment and life insurance contracts, see section 72 and the regulations thereunder;

(3) Life insurance proceeds paid by reason of death of insured, employees' death benefits, see section 101 and the regulations thereunder;

(4) Annuities paid by employees' trusts, see section 402 and the regulations thereunder;

(5) Annuities purchased for employee by employer, see section 403 and the regulations thereunder.

§ 1.61-11 PENSIONS.—(a) *In general*.—Pensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law. Usually, where the taxpayer did not contribute to the cost of a pension and was not taxable on his employer's contributions, the full amount of the pension is to be included in his gross income. But see sections 72, 402, and 403, and the regulations thereunder. When amounts are received from other types of pensions, a portion of the payment may be excluded from gross income. Under some circumstances, amounts distributed from a pension plan in excess of the employee's contributions may constitute long-term capital gain, rather than ordinary income.

(b) *Cross references*.—For the inclusion of pensions in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Detailed rules concerning the extent to which pensions and retirement allowances are to be included in or excluded from gross income are contained in other sections of the Internal Revenue Code of 1954 and the regulations thereunder. Amounts received as pensions or annuities under the Social Security Act or the Railroad Retirement Act are excluded from gross income. For other partial and total exclusions from gross income, see the following:

(1) Annuities in general, section 72 and the regulations thereunder;

(2) Employees' annuities, sections 402 and 403 and the regulations thereunder;

(3) References to other acts of Congress exempting veterans' pensions and railroad retirement annuities and pensions, section 121.

§ 1.61-12 INCOME FROM DISCHARGE OF INDEBTEDNESS.—(a) *In general*.—The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(b) *Proceedings under Bankruptcy Act*.—(1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U. S. C. 32), of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his



creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, unless one of the principal purposes of seeking a confirmation under the Bankruptcy Act is the avoidance of income tax, income is not realized by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(i) A plan of corporate reorganization confirmed under Chapter X of the Bankruptcy Act (11 U. S. C., c. 10);

(ii) An "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act (11 U. S. C., c. 11, 12); or

(iii) A "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act (11 U. S. C., c. 13).

(2) For adjustment of basis of certain property in the case of cancellation of reduction of indebtedness resulting from a proceeding under the Bankruptcy Act, see the regulations under section 1016.

(c) *Sale and purchase by corporation of its bonds.*—(1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is income for the taxable year.

(2) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium, the net amount of such premium is income which should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price, minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income), over the purchase price is income for the taxable year.

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted

(or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

(4) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the face value of the bonds, the excess of the purchase price over the face value is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the face value, the excess of the face value over the purchase price is income for the taxable year.

(d) *Gross references.*—For exclusion from gross income of—

(1) Income from discharge of indebtedness in certain cases, see sections 108 and 1017, and regulations thereunder;

(2) Forgiveness of Government payments to encourage exploration, development, and mining for defense purposes, see section 621 and regulations thereunder.

§ 1.61-13 DISTRIBUTIVE SHARE OF PARTNERSHIP GROSS INCOME; INCOME IN RESPECT OF A DECEDENT; INCOME FROM AN INTEREST IN AN ESTATE OR TRUST.—(a) *In general.*—A partner's distributive share of partnership gross income (under section 702 (c)) constitutes gross income to him. Income in respect of a decedent (under section 691) constitutes gross income to the recipient. Income from an interest in an estate or trust constitutes gross income under the detailed rules of sections 641 through 683. In many cases, these sections also determine who is to include in his gross income the income from an estate or trust.

(b) *Creation of sinking fund by corporation.*—If a corporation, for the sole purpose of securing the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

§ 1.61-14 MISCELLANEOUS ITEMS OF GROSS INCOME.—(a) *In general.*—In addition to the items enumerated in section 61 (a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

(b) *Gross references.*—(1) Prizes and awards, see section 74 and regulations thereunder;

(2) Damages for personal injury or sickness, see section 104 and the regulations thereunder;

(3) Income taxes paid by lessee corporation, see section 110 and regulations thereunder;

- (4) Scholarships and fellowship grants, see section 117 and regulations thereunder;
- (5) Miscellaneous exemptions under other Acts of Congress, see section 121;
- (6) Tax-free covenant bonds, see section 1451 and regulations thereunder.

## § 1.62 STATUTORY PROVISIONS; ADJUSTED GROSS INCOME DEFINED.

### SEC. 62. ADJUSTED GROSS INCOME DEFINED.

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) **TRADE AND BUSINESS DEDUCTIONS.**—The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) **TRADE AND BUSINESS DEDUCTIONS OF EMPLOYEES.**—

(A) **REIMBURSED EXPENSES.**—The deductions allowed by part VI (sec. 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

(B) **EXPENSES FOR TRAVEL AWAY FROM HOME.**—The deductions allowed by part VI (sec. 161 and following) which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(C) **TRANSPORTATION EXPENSES.**—The deductions allowed by part VI (sec. 161 and following) which consist of expenses of transportation paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(D) **OUTSIDE SALESMEN.**—The deductions allowed by part VI (sec. 161 and following) which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer.

(3) **LONG-TERM CAPITAL GAINS.**—The deduction allowed by section 1202.

(4) **LOSSES FROM SALE OR EXCHANGE OF PROPERTY.**—The deductions allowed by part VI (sec. 161 and following) as losses from the sale or exchange of property.

(5) **DEDUCTIONS ATTRIBUTABLE TO RENTS AND ROYALTIES.**—The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.

(6) **CERTAIN DEDUCTIONS OF LIFE TENANTS AND INCOME BENEFICIARIES OF PROPERTY.**—In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by section 167 and the deduction allowed by section 611.

Nothing in this section shall permit the same item to be deducted more than once.

§ 1.62-1 **ADJUSTED GROSS INCOME.**—(a) The term "adjusted gross income" means the gross income computed under section 61 minus such of the deductions allowed by chapter 1 of the Internal Revenue Code of 1954 as are specified in section 62. Adjusted gross income is used as the basis for the determination of the following:

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(1) The optional tax if adjusted gross income is less than \$5,000 (under section 3);

(2) The amount of the standard deduction (under section 141);

(3) The limitation on the amount of the deduction for charitable contributions (under section 170 (b) (1));

(4) The limitation on the amount of the deduction for medical and dental expenses (under section 213); and

(5) In certain cases, the limitation on the deduction for expenses of care of certain dependents (under section 214).

(b) Section 62 merely specifies which of the deductions provided in chapter 1 of the Internal Revenue Code of 1954 shall be allowed in computing adjusted gross income. It does not create any new deductions. The fact that a particular item may be specified in more than one of the paragraphs under section 62 does not permit the item to be twice deducted in computing either adjusted gross income or taxable income.

(c) The deductions specified in section 62 for the purpose of computing adjusted gross income are:

(1) Deductions allowable under chapter 1 (other than by part VII of subchapter B (sections 211 through 216)) which are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee;

(2) Deductions allowable under part VI of subchapter B (sections 161 through 177) which consist of expenses paid or incurred in connection with the performance of services by the taxpayer as an employee under a reimbursement or other expense-allowance arrangement with his employer;

(3) Deductions allowable under part VI which constitute expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee;

(4) Transportation expenses (as defined in paragraph (g) of this section) paid or incurred by the taxpayer in connection with the performance by him of services as an employee, allowable as a deduction under part VI;

(5) Deductions allowable by part VI which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer;

(6) The deduction for long-term capital gains allowed by section 1202;

(7) Deductions which are allowable under part VI as losses from the sale or exchange of property;

(8) Deductions allowable under part VI, section 212, and section 611 which are attributable to property held for the production of rents or royalties; and

(9) Deductions for depreciation and depletion allowable under sections 167 and 611 to a life tenant of property or to an income beneficiary of property held in trust or to an heir, legatee, or devisee of an estate.

(d) For the purpose of the deductions specified in section 62, the

performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible, but State taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) Traveling expenses paid or incurred by an employee in connection with his employment while away from home which are deductible from gross income under part VI in computing taxable income may be deducted from gross income in computing adjusted gross income. Among the items included in traveling expenses are charges for transportation of persons or baggage, expenditures for meals and lodging, and payments for the use of sample rooms for the display of goods. See section 162 and the regulations thereunder.

(f) (1) Expenses paid or incurred by an employee which are deductible from gross income under part VI in computing taxable income and for which he is reimbursed by the employer under an express agreement for reimbursement or pursuant to an expense allowance arrangement may be deducted from gross income in computing adjusted gross income. Where an employee is reimbursed by his employer in an amount less than his total expense, and the reimbursement is intended to cover all types of deductible expenses, expenses other than those described in section 62(2) (B), (C), and (D) are taken into account in computing adjusted gross income in an amount which bears the same ratio to the amount of the reimbursement as the total amount of deductible expenses computed without those described in section 62(2) (B), (C), and (D) bears to the total amount of deductible expenses, including those described in section 62(2) (B), (C), and (D).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* S, who is not a full-time outside salesman, received a salary of \$20,000 and an expense allowance of \$1,200 for the calendar year 1954. He expended \$800 for travel, meals, and lodging while away from home, \$500 for local transportation expenses and \$300 for the entertainment of customers. His adjusted gross income is computed as follows:

Salary .....	\$20,000
Expense allowance .....	1,200
Gross income .....	<hr/> \$21,200
Less: Travel, meals and lodging while away from home .....	\$800

Transportation expense .....	500	
*Reimbursed expenses .....	225	1,525

Adjusted gross income ..... \$19,675

\*The amount of the reimbursement allocable to entertainment expenses is determined as follows:

Travel, meals, and lodging while away from home.....	\$800
Transportation expense .....	500

Expenses deductible in arriving at adjusted gross income (whether or not reimbursed) .....	\$1,300
Entertainment expenses .....	300

Total expenses ..... \$1,600

Deductible for adjusted gross income:  $300/1600 \times \$1,200$  (Expense allowance) = \$225.

(g) Transportation expenses paid or incurred by an employee in connection with performance by him of services for his employer are deductible from gross income under part VI in computing adjusted gross income. "Transportation", as used in section 62 (2) (C), is a narrower concept than "travel", as used in section 62 (2) (B), and does not include meals and lodging. The term "transportation expense" includes only the cost of transporting the employee from one place to another in the course of his employment, while he is not away from home in a travel status. Thus, transportation costs may include cab fares, bus fares, and the like, and also a pro rata share of the employee's expenses of operating his automobile, including gas, oil, and depreciation. All transportation expenses must be allowable expenses under part VI of subchapter B (section 161 and following) as ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business as an employee. Transportation expenses do not include the cost of commuting to and from work; this cost constitutes a personal, living, or family expense and is not deductible. (See section 262.)

(h) The expenses of an employee attributable to the trade or business carried on as an outside salesman which are allowed by part VI of subchapter B (section 161 and following) are deductible from gross income in computing adjusted gross income. An outside salesman is an individual who solicits business as a full-time salesman for his employer away from his employer's place of business. The term "outside salesman" does not include a taxpayer whose principal activities consist of service and delivery. For example, a bread driver-salesman or a milk driver-salesman would not be included within the definition. However, an outside salesman may perform incidental inside activities at his employer's place of business, such as writing up and transmitting orders and spending short periods at the employer's place of business to make and receive telephone calls, without losing his classification as an outside salesman.

## § 1.63 STATUTORY PROVISIONS; TAXABLE INCOME DEFINED.

### SEC. 63. TAXABLE INCOME DEFINED.

(a) GENERAL RULE.—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

(b) INDIVIDUALS ELECTING STANDARD DEDUCTION.—In the case of an individual electing under section 144 to use the standard deduction provided in part IV (sec. 141 and following), for purposes of this subtitle the term "taxable income" means adjusted gross income, minus—

- (1) such standard deduction, and
- (2) the deductions for personal exemptions provided in section 151.

#### ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

### § 1.71 STATUTORY PROVISIONS; ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

#### SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

##### (a) GENERAL RULE.—

(1) DECREE OF DIVORCE OR SEPARATE MAINTENANCE.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) WRITTEN SEPARATION AGREEMENT.—If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not apply if the husband and wife make a single return jointly.

(3) DECREE FOR SUPPORT.—If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

(b) PAYMENTS TO SUPPORT MINOR CHILDREN.—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

##### (c) PRINCIPAL SUM PAID IN INSTALLMENTS.—

(1) GENERAL RULE.—For purposes of subsection (a), installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement shall not be treated as periodic payments.

(2) WHERE PERIOD FOR PAYMENT IS MORE THAN 10 YEARS.—If, by the terms of the decree, instrument, or agreement, the principal sum referred to in paragraph (1) is to be paid or may be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement, then (notwithstanding paragraph (1)) the installment payments shall be treated as periodic payments for purposes of subsection (a), but (in the case of any one taxable year of the wife) only to the extent of 10 percent of the principal sum. For purposes of the preceding sentence, the part of any principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be treated as an installment payment for the taxable year in which it is received.

(d) RULE FOR HUSBAND IN CASE OF TRANSFERRED PROPERTY.—The hus-

band's gross income does not include amounts received which, under subsection (a), are (1) includible in the gross income of the wife, and (2) attributable to transferred property.

(e) CROSS REFERENCES.—

(1) For definitions of "husband" and "wife", see section 7701(a)(17).

(2) For deduction by husband of periodic payments not attributable to transferred property, see section 215.

(3) For taxable status of income of an estate or trust in case of divorce, etc., see section 682.

§ 1.71-1 ALIMONY AND SEPARATE MAINTENANCE PAYMENTS; INCOME TO WIFE OR FORMER WIFE.—(a) *In general*.—Section 71 provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated. For convenience, the payee spouse will hereafter in this section be referred to as the "wife" and the spouse from whom she is divorced or separated as the "husband". See section 7701(a)(17). For rules relative to the deduction by the husband of periodic payments not attributable to transferred property, see section 215 and the regulations thereunder. For rules relative to the taxable status of income of an estate or trust in case of divorce, etc., see section 682 and the regulations thereunder.

(b) *Alimony or separate maintenance payments received from the husband*.—(1) *Decree of divorce or separate maintenance*.—(i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a court order or decree divorcing or legally separating the husband and wife or a written instrument incident to such divorce status or legal separation status.

(ii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(2) *Written separation agreement*.—(i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her pursuant to a written separation agreement executed after August 16, 1954. The periodic payments must be made under the terms of the written separation agreement after its execution and because of the marital or family relationship. Such payments are includible in the wife's gross income whether or not the agreement is a legally enforceable instrument. Moreover, if the wife is divorced or legally separated subsequent to the written separation agreement, payments made under such agreement continue to fall within the provisions of section 71(a)(2).

(ii) For purposes of section 71(a)(2), any written separation agreement executed on or before August 16, 1954, which is altered or modified in writing by the parties in any material respect after that



date will be treated as an agreement executed after August 16, 1954, with respect to payments made after the date of alteration or modification.

(iii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(3) *Decree for support.*—(i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (3) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after August 16, 1954, from her husband under any type of court order or decree (including an interlocutory decree of divorce or a decree of alimony pendente lite) entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. It is not necessary for the wife to be legally separated or divorced from her husband under a court order or decree; nor is it necessary for the order or decree for support to be for the purpose of enforcing a written separation agreement.

(ii) For purposes of section 71(a) (3), any decree which is altered or modified by a court order entered after March 1, 1954, will be treated as a decree entered after such date.

(4) *Scope of section 71(a).*—Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71(a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

(5) *Year of inclusion.*—Periodic payments are includible in the wife's income under section 71(a) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements method, regardless of whether she normally makes such returns on the accrual method. However, if the periodic payments described in section 71(a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662, and 682, whether or not such payments are made out of the income of such estates or trusts.

(6) *Examples.*—The foregoing rules are illustrated by the following examples in which it is assumed that the husband and wife file separate income tax returns on the calendar year basis:

*Example (1).* W files suit for divorce from H in 1953. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H agrees in writing to pay \$200 a month to W during her lifetime if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered December 31, 1953. During 1954, H pays W \$200 a month, pursuant to the promise. The \$2,400 thus

received by W is includible in her gross income under the provisions of section 71(a)(1). Under section 215, H is entitled to a deduction of \$2,400 from his gross income.

*Example (2).* During 1945, H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W \$200 a month during her lifetime. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 71(a) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce status, section 71(a)(1) would require the inclusion in W's gross income of the payments received by her after the decree. Similarly, if a written separation agreement were executed after August 16, 1954, and incorporated the payment provisions of the antenuptial agreement, section 71(a)(2) would require the inclusion in W's income of payments received by W after W begins living apart from H, whether or not the divorce decree was subsequently entered and whether or not W was living apart from H when the separation agreement was executed, provided that such payments were made after such agreement was executed and pursuant to its terms. As to including such payments in W's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, or created pursuant to the written separation agreement, see section 682 and the regulations thereunder.

*Example (3).* H and W are separated and living apart during 1954. W sues H for support and on February 1, 1954, the court enters a decree requiring H to pay \$200 a month to W for her support and maintenance. No part of the \$200 a month support payments is includible in W's income under section 71(a)(3) or deductible by H under section 215. If, however, the decree had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, the payments received by W after August 16, 1954, under the decree as altered or modified would be includible in her income under section 71(a)(3) and deductible by H under section 215.

*Example (4).* W sues H for divorce in 1954. On January 15, 1954, the court awards W temporary alimony of \$25 a week pending the final decree. On September 1, 1954, the court grants W a divorce and awards her \$200 a month permanent alimony. No part of the \$25 a week temporary alimony received prior to the decree is includible in W's income under section 71(a), but the \$200 a month received during the remainder of 1954 by W is includible in her income for 1954. Under section 215, H is entitled to deduct such \$200 payments from his income. If, however, the decree awarding W temporary alimony had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954,

temporary alimony received by her after August 16, 1954, would be includible in her income under section 71(a)(3) and deductible by H under section 215.

(c) *Alimony and separate maintenance payments attributable to property.*—(1) (i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) attributable to property transferred, in trust or otherwise, and received by her after a decree of divorce or of separate maintenance. Such property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a decree of divorce or separate maintenance or under a written instrument incident to such divorce status or legal separation status.

(ii) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her which are attributable to property transferred, in trust or otherwise, under a written separation agreement executed after August 16, 1954. The property must be transferred because of the marital or family relationship. The periodic payments attributable to the property must be received by the wife after the written separation agreement is executed.

(iii) The periodic payments received by the wife attributable to property transferred under subdivisions (i) and (ii) of this subparagraph and includible in her gross income are not to be included in the gross income of the husband.

(2) The full amount of periodic payments received under the circumstances described in section 71(a) (1), (2), and (3) is required to be included in the gross income of the wife regardless of the source of such payments. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the husband from his income or capital. For example, if in order to meet an alimony or separate maintenance obligation of \$500 a month the husband purchases or assigns for the benefit of his wife a commercial annuity contract paying such amount, the full \$500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 72(k) and the regulations thereunder. Likewise, if property is transferred by the husband, subject to an annual charge of \$5,000, payable to his wife in discharge of his alimony or separate maintenance obligation under the divorce or separation decree or written instrument incident to the divorce status or legal separation status or if such property is transferred pursuant to a written separation agreement and subject to a similar annual charge, the \$5,000 received annually is, under section 71(a) (1) or (2), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(3) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which

section 71(a) (1) and (2) applies is includible in the wife's income regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 71(a) (1) or (2) and are to be excluded from the husband's income even though the income of the trust would otherwise be includible in his income under subpart E, part I, subchapter J, Internal Revenue Code of 1954, relating to trust income attributable to grantors and others as substantial owners. As to periodic payments received by a wife attributable to property in trust in cases to which section 71(a) (1) or (2) does not apply because the husband's obligation is not specified in the decree or an instrument incident to the divorce status or legal separation status or the property was not transferred under a written separation agreement, see section 682 and the regulations thereunder.

(4) Section 71(a) (1) or (2) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident to the divorce status or legal separation status, or transferred pursuant to the written separation agreement, which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife attributable to the husband's interest in the securities transferred in discharge of his obligation under the decree, or instrument incident to the divorce status or legal separation status, or transferred under the written separation agreement, is taxable to her under section 71(a) (1) or (2), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in part I of subchapter J. If, however, the husband's transfer to his wife is made before such property is transferred in discharge of his obligation under the decree or written instrument, or pursuant to the separation agreement in an attempt to avoid the application of section 71(a) (1) or (2) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation or pursuant to such agreement. In such a case, section 71(a) (1) or (2) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see section 72 and the regulations thereunder.

(d) *Periodic and installment payments.*—(1) In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement are not considered "periodic payments" and therefore are not to be included under section 71(a) in the wife's income.

(2) An exception to the general rule stated in subparagraph (1) of

this paragraph is provided, however, in cases where such principal sum, by the terms of the decree, instrument, or agreement, may be or is to be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement. In such cases, the installment payment is considered a periodic payment for the purposes of section 71(a) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal sum. This 10-percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(3) (i) Where payments under a decree, instrument, or agreement are to be paid over a period ending 10 years or less from the date of such decree, instrument, or agreement, such payments are not installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement (and are considered periodic payments for the purposes of section 71(a)) only if such payments meet the following two conditions:

(a) Such payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, and

(b) Such payments are in the nature of alimony or an allowance for support.

(ii) Payments meeting the requirements of subdivision (i) are considered periodic payments for the purposes of section 71 (a) regardless of whether—

(a) The contingencies described in subdivision (i) (a) are set forth in the terms of the decree, instrument, or agreement, or are imposed by local law, or

(b) The aggregate amount of the payments to be made in the absence of the occurrence of the contingencies described in subdivision (i)(a) of this subparagraph is explicitly stated in the decree, instrument, or agreement or may be calculated from the face of the decree, instrument, or agreement, or

(c) The total amount which will be paid may be calculated actuarially.

(4) Where payments under a decree, instrument, or agreement are to be paid over a period ending more than ten years from the date of such decree, instrument, or agreement, but where such payments meet the conditions set forth in subparagraph (3)(i) of this paragraph, such payments are considered to be periodic payments for the purpose of section 71 without regard to the rule set forth in subparagraph (2) of this paragraph. Accordingly, the rules set forth in subparagraph (2) of this paragraph are not applicable to such payments.

(5) The rules as to periodic and installment payments are illustrated by the following examples:

*Example (1).* Under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of \$100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic.

*Example (2).* The facts are the same as in example (1) except that the written instrument explicitly provides that H is to pay W the sum of \$10,800 in monthly payments of \$100 over a period of nine years. The payments are periodic.

*Example (3).* Under the terms of a written instrument, H is to pay W \$100 a month over a period of nine years. The monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the written instrument or by reason of local law. The payments are not periodic.

*Example (4).* A divorce decree in 1954 provides that H is to pay W \$20,000 each year for the next five years, beginning with the date of the decree, and then \$5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1954 to 1958, inclusive, is treated as a periodic payment under section 71(a)(1), but only to the extent of 10 percent of the principal sum of \$150,000. Thus, for such taxable years, only \$15,000 of the \$20,000 received is includible under section 71(a)(1) in the wife's income and is deductible by the husband under section 215. For the years 1959 to 1968, inclusive, the full \$5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

(e) *Payments for support of minor children.*—Section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71(a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay \$200 a month to his divorced wife, \$100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only \$150 to his wife, \$100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71(a). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 71(a) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

§ 1.71-2 EFFECTIVE DATE; TAXABLE YEARS ENDING AFTER MARCH 31, 1954, SUBJECT TO THE INTERNAL REVENUE CODE OF 1939.—Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.71-1, to the extent that they relate to payments under a written

separation agreement executed after August 16, 1954, and to the extent that they relate to payments under a decree for support received after August 16, 1954, under a decree entered after March 1, 1954, shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, although such years are subject to the Internal Revenue Code of 1939.

#### ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

### § 1.101 STATUTORY PROVISIONS; CERTAIN DEATH BENEFITS.

#### SEC. 101. CERTAIN DEATH BENEFITS.

##### (a) PROCEEDS OF LIFE INSURANCE CONTRACTS PAYABLE BY REASON OF DEATH.—

(1) GENERAL RULE.—Except as otherwise provided in paragraph (2) and in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

(2) TRANSFER FOR VALUABLE CONSIDERATION.—In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

##### (b) EMPLOYEES' DEATH BENEFITS.—

(1) GENERAL RULE.—Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee.

##### (2) SPECIAL RULES FOR PARAGRAPH (1).—

(A) \$5,000 LIMITATION.—The aggregate amounts excludable under paragraph (1) with respect to the death of any employee shall not exceed \$5,000.

(B) NONFORFEITABLE RIGHTS.—Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than total distributions payable, as defined in section 402(a)(3), which are paid to a distributee, by a stock bonus, pension, or profit-sharing trust described in section 401(a) which is exempt from tax under section 501(a), or under an annuity contract under a plan which meets the requirements of paragraphs (3), (4), (5), and (6) of section 401(a), within one taxable year of the distributee by reason of the employee's death).

(C) JOINT AND SURVIVOR ANNUITIES.—Paragraph (1) shall not apply to amounts received by a surviving annuitant under a joint and survivor's annuity contract after the first day of the first period for which an amount was received as an annuity by the employee (or would have been received if the employee had lived).

(D) OTHER ANNUITIES.—In the case of any amount to which section 72 (relating to annuities, etc.) applies, the amount which is excludable under paragraph (1) (as modified by the preceding subparagraphs of this paragraph) shall be determined by reference to the value of such amount as of the day on which the employee died. Any amount so excludable under paragraph (1) shall, for purposes of section 72, be treated as additional consideration paid by the employee.

(c) EXCLUDED. If any amount excluded from gross income by subsection (a) or (b) is held under an agreement to pay interest thereon, the interest payments shall be included in the gross income.

(d) PAYMENT OF LIFE INSURANCE PROCEEDS AT A DATE LATER THAN DEATH.

(1) GENERAL RULE. The amount held by an insurer with respect to any beneficiary shall be prorated in accordance with such regulations as may be prescribed by the Secretary or his delegate over the period or periods with respect to which such payments are to be made. There shall be excluded from the gross income of such beneficiary in the taxable year received

(A) any amount determined by such proration, and

(B) in the case of the surviving spouse of the insured, that portion of the estate of the amount received under one or more agreements specified in paragraph (2) (A) (whether or not payment of any part of such amount is guaranteed by the insurer) over the amount determined in subparagraph (A) of this paragraph which is not greater than \$1,000 with respect to any insured.

Gross income includes, to the extent not excluded by the preceding sentence, amount received under agreements to which this subsection applies.

(2) AMOUNT DETERMINED BY SUCH. An amount held by an insurer with respect to any beneficiary shall mean an amount to which subsection (a) applies which is

(A) held by any insurer under an agreement provided for in the life insurance contract, whether as an option or otherwise, to pay such amount on a date or dates later than the death of the insured, and

(B) equal to the value of such agreement to such beneficiary.

(3) as of the date of death of the insured (as if any option exercised under the life insurance contract were exercised at such time); and

(4) as determined on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement.

(3) SURVIVING SPOUSE. For purposes of this subsection, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated but not under a decree of absolute divorce.

(4) APPLICATION OF SUBSECTION. This subsection shall not apply to any amount to which subsection (a) is applicable.

(e) ALIEN OR, PAYMENTS.

(1) IN GENERAL. This section shall not apply to so much of any payment as is includible in the gross income of the wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) CHOICE OF RESIDENCE. For definition of "wife", see section 7701(a) (17C).

(f) EFFECTIVE DATE OF THIS PROVISION. This section shall apply only to amounts received by reason of the death of an insured or an employee occurring after the date of enactment of this title. Section 22(b)(1) of the Internal Revenue Code of 1939 shall apply to amounts received by reason of the death of an insured or an employee occurring on or before such date.

§ 1.101-1 EXCLUSION FROM GROSS INCOME OF PROCEEDS OF LIFE INSURANCE CONTRACTS PAYABLE BY REASON OF DEATH.—(a) *In general.* Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employ-



section 101(b) and § 1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death. See §§ 1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee under pension, profit-sharing, or stock bonus plans described in section 410(a) and exempt under section 501(a), or under annuity plans meeting the requirements of section 401(a)(3), (4), (5), and (6), see also section 402(a) and 403(a) and the regulations thereunder. For the definition of a life insurance company, see section 801.

(b) *Transfers of life insurance policies.*—(1) In the case of a transfer, by assignment or otherwise, of a life insurance policy or any interest therein for a valuable consideration, the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income is generally limited to the sum of (i) the actual value of the consideration for such transfer, and (ii) the premiums and other amounts subsequently paid by the transferee (see section 101(a)(2) and example (1) of subparagraph (5) of this paragraph). However, this limitation on the amount excludable from the transferee's gross income does not apply (except in certain special cases involving a series of transfers), where the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest in the hands of the transferor (see section 101(a)(2)(A) and examples (2) and (4) of subparagraph (5) of this paragraph). Neither does the limitation apply where the policy or interest therein is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)). For rules relating to gratuitous transfers, see subparagraph (2) of this paragraph. For special rules with respect to certain cases where a series of transfers is involved, see subparagraph (3) of this paragraph.

(2) In the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, as a general rule the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income under section 101(a) is limited to the sum of (i) the amount which would have

been excludable by the transferor (in accordance with this section) if no such transfer had taken place, and (ii) any premiums and other amounts subsequently paid by the transferee. See example (6) of subparagraph (5) of this paragraph. However, where the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred shall be excludable from the transferee's gross income (see section 101(a)(2)(B) and examples (7) of subparagraph (5) of this paragraph).

(3) In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration—

(i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—

(a) The actual value of the consideration paid by him, and

(b) The premiums and other amounts subsequently paid by him;

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(a) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(b) Any premiums and other amounts subsequently paid by the final transferee himself.

(4) For the purposes of section 101(a)(2) and subparagraphs (1) and (3) of this paragraph, a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

(5) The application of this paragraph may be illustrated by the following examples:

*Example (1).* A pays premiums of \$500 for an insurance policy in the face amount of \$1,000 upon the life of B, and subsequently transfers the policy to C for \$600. C receives the proceeds of \$1,000 upon the death of B. The amount which C can exclude from his

gross income is limited to \$600 plus any premiums paid by C subsequent to the transfer.

*Example (2).* The X Corporation purchases for a single premium of \$500 an insurance policy in the face amount of \$1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of the Y Corporation.

*Example (3).* The facts are the same as in example (2) except that, prior to the death of A, the Y Corporation transfers the policy to the Z Corporation for \$600. The Z Corporation receives the proceeds of \$1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to \$600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

*Example (4).* The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the M Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the M Corporation determined by reference to its basis in the hands of the Z Corporation). The M Corporation receives the proceeds of \$1,000 upon the death of A. The amount which the M Corporation can exclude from its gross income is limited to \$600 plus any premiums paid by the Z Corporation and the M Corporation subsequent to the transfer of the policy to the Z Corporation.

*Example (5).* The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of the N Corporation.

*Example (6).* A pays premiums of \$500 for an insurance policy in the face amount of \$1,000 upon his own life, and subsequently transfers the policy to his wife B for \$600. B later transfers the policy without consideration to C, who is the son of A and B. C receives the proceeds of \$1,000 upon the death of A. The amount which C can exclude from his gross income is limited to \$600 plus any premiums paid by B and C subsequent to the transfer of the policy to B.

*Example (7).* The facts are the same as in example (6) except that, prior to the death of A, C transfers the policy without consideration to A, the insured. A's estate receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of A's estate.

§ 1.101-2 EMPLOYEES' DEATH BENEFITS.—(a) *In general.*—(1) Section 101(b) states the general rule that amounts up to \$5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death

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of the employee shall be excluded from the gross income of the recipient. This exclusion from gross income applies whether payment is made to the estate of the employee or to any beneficiary (individual, corporation, or partnership), whether it is made directly or in trust, and whether or not it is made pursuant to a contractual obligation of the employer. The exclusion applies whether payment is made in a single sum or otherwise, subject to the provisions of section 101(c), relating to amounts held under an agreement to pay interest thereon (see § 1.101-3). The exclusion from gross income also applies to any amount not actually paid which is otherwise taxable to a beneficiary of an employee because it was made available as a distribution from an employee's trust.

(2) The exclusion does not apply to amounts constituting income payable to the employee during his life as compensation for his services, such as bonuses or payments for unused leave or uncollected salary, nor to certain other amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b)(2)(B) and paragraph (d) of this section). Further, the exclusion does not apply to amounts received as an annuity under a joint and survivor annuity obligation where the employee was the primary annuitant and the annuity starting date occurred before the death of the employee (see section 101(b)(2)(C) and paragraph (e)(1)(ii) of this section). In the case of amounts received by a beneficiary as an annuity (but not as a survivor under a joint and survivor annuity with respect to which the employee was the primary annuitant), the exclusion is applied indirectly by means of the provisions of section 72 and the regulations thereunder (see section 101(b)(2)(D) and paragraph (e)(1)(iii) and (iv) of this section).

(3) The total amount excludable with respect to any employee may not exceed \$5,000, regardless of the number of employers or the number of beneficiaries. For allocation of the exclusion among beneficiaries, see paragraph (c) of this section. For rules governing the taxability of benefits payable on the death of an employee under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt under section 501(a), or under annuity plans meeting the requirements of section 401(a) (3), (4), (5), and (6), see also sections 402(a) and 403(a) and the regulations thereunder.

(b) *Payments under certain employee benefit plans.*—Where a payment is made by reason of the death of an employee by an employer-provided welfare fund or a trust, including a stock bonus, pension, or profit-sharing trust described in section 401(a), or by an insurance company (if such payment does not constitute "life insurance" within the purview of section 101(a)), the payment shall be considered to have been made by or on behalf of the employer to the extent that it exceeds amounts contributed by, or deemed contributed by, the deceased employee. For provisions governing the taxability of distributions payable on the death of an employee participant under a trust described in section 401(a) and exempt under section 501(a), which has purchased annuity contracts, life insurance contracts, or retirement income contracts with life insurance protection, see paragraph (a)(4) of § 1.402(a)-1. For provisions governing the taxability of

distributions payable on the death of an employee under nontrusteed plans, see paragraphs (c) and (d) of § 1.403(a)-1.

(c) *Allocation of the exclusion.*—(1) Where the aggregate payments by or on behalf of an employer or employers as death benefits to the beneficiaries or the estate of a deceased employee exceed \$5,000, the \$5,000 exclusion shall be apportioned among them in the same proportion as the amount received by or the present value of the amount payable to each bears to the total death benefits paid or payable by or on behalf of the employer or employers.

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* The M Corporation, the employer of A, a deceased employee who died November 30, 1954, makes payments in 1955 to the beneficiaries of A as follows: \$5,000 to W, A's widow, \$2,000 to B, the son of A, and \$3,000 to C, the daughter of A. No other amounts are paid by any other employer of A to his estate or beneficiaries. By application of the apportionment rule stated above, W, the widow, will exclude \$2,500 ( $\$5,000/\$10,000$ , or one-half, of \$5,000); B, the son will exclude \$1,000 ( $\$2,000/\$10,000$ , or one-fifth, of \$5,000); and C, the daughter, will exclude \$1,500 ( $\$3,000/\$10,000$ , or three-tenths, of \$5,000).

(d) *Nonforfeitable rights.*—(1) Except as provided in subparagraph (3) of this paragraph, the exclusion provided by section 101(b) does not apply to amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living. Section 101(b)(2)(B). For the purpose of section 101(b) and this paragraph, an employee shall be considered to have had a nonforfeitable right with respect to—

(i) Any amount to which he would have been entitled—

(a) If he had made an appropriate election or demand, or

(b) Upon termination of his employment,

(see examples (5) and (6) of subparagraph (2) of this paragraph); or

(ii) The present value (immediately before his death) of—

(a) Amounts payable as an annuity (as defined in paragraph

(b) of § 1.72-2, whether immediate or deferred) by or on behalf of the employer (see example (1) of subparagraph (2) of this paragraph), or

(b) Amounts which would have been so payable if the employee had terminated his employment and continued to live;

or

(iii) Any amount to the extent it is paid in lieu of amounts described in either subdivision (i) or (ii) of this subparagraph. See examples (2), (3), and (4) of subparagraph (2) of this paragraph.

For purposes of subdivision (iii) of this subparagraph, any amount paid in discharge of an obligation which arose solely because of the existence of a particular fact or circumstance subsequent to the employee's death shall not be considered an amount paid in lieu of amounts described in subdivision (i) or (ii) of this subparagraph. Subdivision (iii) of this subparagraph shall apply, however, to the extent indicated therein, to amounts payable without regard to any such contingency (to the extent that such amounts are equal to or less than those described in subdivision (i) and (ii) of this subparagraph

which are not paid). See paragraph (e)(1)(iii)(b) of this section for rules with respect to finding the present value of an annuity immediately before the employee's death.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples, in which it is assumed that the plans are not "qualified" plans:

*Example (1).* A, who was a participant under the X Company pension plan, retired on December 31, 1953. He had made no contributions to the plan. Upon his retirement, he became entitled to monthly payments of \$100 payable for life, or 120 months certain. A died on October 31, 1954, having received 10 monthly payments of \$100 each. After his death, the monthly payments became payable to his estate for the remaining 110 months certain. No exclusion from gross income is allowed to A's estate (or any beneficiary who receives the right to such payments from the estate), since the employee's right to the monthly payments was nonforfeitable at the date of his death. It will be noted that in this example it is unnecessary to consider the present value of the annuity to A just before his death since the payments to be made include only those certain to be made in any event under the plan whether or not A continued to live.

*Example (2).* C, a participant under the Y Company pension plan, died on December 15, 1954, while actively in the employment of the company, survived by a widow and minor children. Because of his years of service, he would have been entitled to an annuity for life, his own contributions to the plan and interest thereon being guaranteed, if he had retired or terminated his employment at a time immediately before his death. The plan further provides that—(a) if, but only if, an employee is survived by a widow and minor children, his widow is to receive an annuity for her life without regard to whether or not the employee had begun his annuity; (b) any payments made with respect to his widow's annuity are to reduce the guaranteed amount to an equal extent; and (c) if the employee is not so survived, the guaranteed amount is payable to his beneficiary or estate, but no amount is payable to anyone with respect to what would have been the widow's annuity. In view of these provisions, that portion of the present value of the annuity payable to C's widow which exceeds the guaranteed amount shall be considered paid neither as an amount, nor in lieu of an amount, which C had a nonforfeitable right to receive while living. The reason for this result is that the payment of such excess is contingent upon C's being survived by a widow and minor children, a circumstance existing subsequent to his death. Conversely, to the extent that the present value of the annuity payable to C's widow does not exceed the guaranteed amount, annuity payments attributable to such present value shall be considered paid in lieu of an amount which C had a nonforfeitable right to receive while living.

*Example (3).* D, a participant under the Y Company pension plan, died on January 1, 1955, while actively in the employment of the company. The Y Company plan provides that where an employee dies in service, the present value of the accumulated credits which he could have obtained at that time if he had instead separated from the

service shall be paid in a single sum to his surviving spouse or to his estate if no widow survives him. The present value of D's accumulated credits, at the time of his death, was \$10,000. However, the plan also provides that a surviving spouse may elect to take, in lieu of a single sum, an annuity the present value of which exceeds such sum by \$2,500. D's widow elects to receive an annuity (the present value of which is \$12,500). Therefore, \$2,500 is an amount to which the exclusion of section 101 (b) and this section shall apply.

*Example (4).* A, an employee of the X Company, continues to work after reaching the normal retirement age of 60 years, although he could have retired at that age and obtained an annuity of \$3,000 per year for his life. A is not entitled to any part of the annuity while he is employed and receiving compensation. A dies at the age of 67 while still in active employment. Since he had passed normal retirement age, his additional years of service did not entitle him to a larger annuity at age 67 than that which he could have obtained at age 60. However, the plan of the X Company provides that in the event of an employee's death prior to separation from the service, his widow is to be paid an annuity for her life in the same amount per year as that which the employee could have obtained if he had instead retired; but if no widow survives him, the present value of the annuity which the employee could have obtained at a time just before his death is to be paid to a named beneficiary or the estate of the employee. Assuming that the present value of the annuity to A's widow, whose age is 61, is \$36,000 and the present value of the annuity which would have been payable to A at age 67 if he had then retired is \$23,500, the present value of the widow's annuity, to the extent of \$23,500, is an amount which is payable in lieu of amounts which the employee had a nonforfeitable right to receive while living because it does not exceed the value of his nonforfeitable rights and is not otherwise paid. On the other hand, the \$12,500 excess of the value of the widow's annuity (\$36,000) over the value of the employee's annuity (\$23,500) is an amount to which section 101(b) applies since the employee had no right to any part of it. If no other death benefits are payable, a \$5,000 exclusion is available (see section 101 (b) (2) (D) and paragraph (e) of this section).

*Example (5).* The trustee of the X Corporation noncontributory profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee in case of termination of employment a 10-percent vested interest in the amount accumulated in his account for each year of participation in the plan. In case of death, the entire credit in the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for three years and the accumulation in his account was \$8,000. After his death this amount is paid to his beneficiary. At the time of B's death, the amount distributable to him on account of termination of employment would have been \$2,400 (30 percent of \$8,000). The difference of \$5,600 (\$8,000 minus \$2,400), payable to the beneficiary of B, is an amount payable solely by reason of B's death. Accordingly, \$5,000 of the

\$5,600 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved). However, if it is assumed that the facts are the same as above, except that at the time of his death B has been a participant for 6 years, the amount distributable to him on account of termination of employment would have been \$4,800 (60 percent of \$8,000). The difference of \$3,200 (\$8,000 minus \$4,800), payable to B's beneficiary, is an amount payable solely by reason of B's death. Accordingly, only \$3,200 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved).

*Example (6).* The X Corporation instituted a trust, forming part of a pension plan, for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that after 10 or more years of service and attaining the age of 55, an employee can elect to retire and receive benefits before the normal retirement date contingent upon the employer's approval. If he retires without the employer's consent, or voluntarily leaves the company, no benefits are or will be payable. The plan further provides that if the employee is involuntarily separated or dies before retirement, he or his beneficiary, respectively, will receive a percentage of the reserve provided for the employee in the trust fund on the following basis: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. A, an employee of the X Corporation for 17 years, died at the age of 56 while in the employ of the corporation. At the time of his death, \$15,000 was the reserve provided for him in the trust. His beneficiary receives \$7,500, an amount equal to 50 percent of the reserve provided for A's retirement; accordingly, \$5,000 of the \$7,500 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved) since A, prior to his death, had only a forfeitable right to receive \$7,500.

(3) (i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income provided by section 101(b) applies to the receipt of certain amounts, paid under "qualified" plans, with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b) (2) (B)). The payments to which this exclusion applies are—

(a) "Total distributions payable" by a stock bonus, pension, or profit-sharing trust described in section 401(a) which is exempt from tax under section 501(a), and

(b) "Total amounts" paid under an annuity contract under a plan meeting the requirements of section 401(a) (3), (4), (5), and (6),

provided such distributions or amounts are paid in full within one taxable year of the distributee (see example (3) of subdivision (ii) of this subparagraph). For the purpose of applying section 101(b), "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the



employee's death, either before or after separation from the service (see section 402(a)(3)(C), the regulations thereunder, and examples (2) and (4) of subdivision (ii) of this subparagraph); and "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death, either before or after separation from the service (see section 403(a)(2)(B), the regulations thereunder, and example (1) of subdivision (ii) of this subparagraph).

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

*Example (1).* The widow of an employee elects, under a noncontributory "qualified" plan, to receive in a lump sum the present value of the annuity which C, the deceased employee, could have obtained at a time just before his death if he had retired at that time. Such present value is \$6,000. Of this amount, \$5,000 is excludable from the widow's gross income despite the fact that C had a nonforfeitable right to the amount in lieu of which the payment is made, since such payment is an amount to which subdivision (i) of this subparagraph applies (assuming no other death benefits are involved).

*Example (2).* The trustee of the X Corporation noncontributory, "qualified", profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee, in case of termination of employment, a 10 percent vested interest in the amount accumulated in his account for each year of participation in the plan, but, in case of death, the entire credit to the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for five years. The accumulation in his account was \$8,000, and the amount which would have been distributable to him in the event of termination of employment was \$4,000 (50 percent of \$8,000). After his death, \$8,000 is paid to his beneficiary in a lump sum. (It may be noted that these are the same facts as in example (5) of subparagraph (2) of this paragraph except that the employee has been a participant for five years instead of three and the plan is a "qualified" plan.) It is immaterial that the employee had a nonforfeitable right to \$4,000, because the payment of the \$8,000 to the beneficiary is the payment of the "total distributions payable" within one taxable year of the distributee to which subdivision (i) of this subparagraph applies. Assuming no other death benefits are involved, the beneficiary may exclude \$5,000 of the \$8,000 payment from gross income.

*Example (3).* The facts are the same as in example (2) except that the beneficiary is entitled to receive only the \$4,000 to which the employee had a nonforfeitable right and elects, 30 days after B's death, to receive it over a period of ten years. Since the "total distributions payable" are not paid within one taxable year of the distributee, no exclusion from gross income is allowable with respect to the \$4,000.

*Example (4).* The X Corporation instituted a trust, forming part of a "qualified" profit-sharing plan for its employees, the cost thereof being borne entirely by the corporation. The plan provides,

in part, that if, after 10 or more years of service, an employee leaves the employ of the corporation, either voluntarily or involuntarily, before retirement, a percentage of the reserve provided for the employee in the trust fund will be paid to the employee as follows: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. The plan further provides that if an employee dies before reaching retirement age, his beneficiary will receive a percentage of the reserve provided for the employee in the trust fund, on the same basis as shown in the preceding sentence. A, an employee of the X Corporation for 17 years, died before attaining retirement age while in the employ of the corporation. At the time of his death, \$15,000 was the reserve provided for him in the trust fund. His beneficiary receives \$7,500 in a lump sum, an amount equal to 50 percent of the reserve provided for A's retirement. The beneficiary may exclude from gross income (assuming no other death benefits are involved) \$5,000 of the \$7,500, since the latter amount constitutes "total distributions payable" paid within one taxable year of the distributee, to which subdivision (i) of this subparagraph applies.

(e) *Annuity payments.*—(1) Where death benefits are paid in the form of annuity payments, the following rules shall govern for purposes of the exclusion provided in section 101(b) :

(i) The exclusion from gross income provided by section 101(b) does not apply to amounts, paid as an annuity, with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or to amounts paid as an annuity in lieu thereof. See paragraph (d) of this section.

(ii) Under section 101(b) (2) (C), no exclusion is allowable for amounts received by a surviving annuitant under a joint and survivor's annuity contract if the annuity starting date (as defined in section 72(c) (4) and paragraph (b) of § 1.72-4) occurs before the death of the employee. If the annuity starting date occurs after the death of the employee, the joint and survivor's annuity contract shall be treated as an annuity to which section 101(b) (2) (D) applies. See subdivision (iii) of this subparagraph.

(iii) (a) Subject to the other limitations stated in section 101(b) and in this section (see section 101(b) (2) (D)), the amount to which the exclusion of section 101(b) shall apply, with respect to "amounts received as an annuity" (as defined in paragraph (b) of § 1.72-2) shall be the amount by which the present value of the annuity to be paid to the beneficiary, computed as of the date of the employee's death, exceeds the value (if any) of whichever of the following is the larger :

(1) Amounts contributed by the employee (determined in accordance with the provisions of section 72 and the regulations thereunder), or

(2) Amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or amounts paid in lieu thereof (see paragraph (d) of this section).

(b) The present value of an annuity (immediately before the death of the employee), to the employee, or (immediately after the death of

the employee), to his estate or beneficiary, shall be determined as follows:

(1) In the case of an annuity paid by an insurance company or by an organization (other than an insurance company) regularly engaged in issuing annuity contracts with an insurance company as the co-insurer or reinsurer of the obligations under the contract, by use of the discount interest rates and mortality tables used by the insurance company involved to determine the installment benefits;

(2) In the case of an annuity paid by an organization (other than an insurance company and other than an organization described in (1) of this subdivision) regularly engaged in issuing annuity contracts, by reference to the cost of a comparable contract purchased from an insurance company; and

(3) In the case of an annuity to which neither (1) nor (2) of this subdivision is applicable, by use of the appropriate tables of § 81.10(i) of Regulations 105 (26 CFR (1939) 81.10 (i)) (pertaining to the estate tax), as supplemented by "Actuarial Values for Estate and Gift Tax" (Internal Revenue Service Publication No. 11, 1955).

(iv) Any amount subject to section 101(b)(2)(D) which is excludable under section 101(b) (see subdivision (iii) of this subparagraph) shall, for purposes of section 72, be treated as additional consideration paid by the employee. See paragraph (b) of § 1.72-8.

(v) Where more than one beneficiary, or more than one death benefit, is involved, the exclusion provided by section 101(b) shall be apportioned to the various beneficiaries and benefits in accordance with the proportion that the present value of each benefit bears to the total present value of all the benefits.

(2) The application of the principles of this paragraph may be illustrated by the following examples:

*Example (1).* (i) Under the plan of the X Corporation, W, who is the widow of employee A, and who is 55 years old at the time of A's death, is entitled to an immediate annuity of \$2,000 per year during her life and C, the minor child of A, is entitled to receive \$1,000 per year for 15 years. A made no contributions under the plan and died while still employed by the X Corporation. At the time of A's death, the amount in his account is \$18,000. Under the terms of the plan, this amount would have been distributable to him on account of voluntary termination of employment, but would not have been payable after his death except in the form of the annuities just described. This amount, accordingly, constitutes a nonforfeitable interest in lieu of which the annuities are paid. The exclusion does not apply, except to the extent that the present value of the annuities exceeds \$18,000, whether or not the plan is "qualified", since the total of the amount in A's account will not be paid within one taxable year of distributees. See subparagraph (1)(i) of this paragraph.

(ii) The computation of the exclusion applicable to the interests of W and C (assuming that the payments will not be made by an insurance company or some other organization regularly engaged in issuing annuity contracts) is, by application of the tables in § 81.10(i) of Regulations 105 (26 CFR (1939) 81.10(i)) (pertaining to the estate tax), as follows: The present value of W's interest is \$26,243.60, determined by multiplying the annual payment of

\$2,000 by 13.1218 (the factor in Table I for a person aged 55); the present value of C's interest is \$11,517.40, determined by multiplying the yearly payment of \$1,000 by 11.5174 (the factor in Table II for payments for a term certain of 15 years). The present value of both annuities is \$37,761 and (assuming no other death benefits are involved), the total amount excludable is \$5,000, because the total present value of the annuities exceeds the employee's nonforfeitable interest by more than \$5,000 (\$37,761 minus \$18,000 equal \$19,761). The exclusion allocable to W's interest is \$26,243.60/\$37,761 times \$5,000, or \$3,474.96; the exclusion allocable to C's interest is \$11,517.40/\$37,761 times \$5,000, or \$1,525.04. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

*Example (2).* The facts are the same as in example (1), except that the nonforfeitable interest of A, at the time of his death, amounted to \$33,761. Since the present value of both annuities (\$37,761) exceeds the value of such nonforfeitable interest by only \$4,000, the latter amount is the total amount excludable from the gross income of the beneficiaries. This \$4,000 exclusion is to be divided in the same proportions as those indicated in example (1). Thus, the exclusion allocable to W's interest is \$26,243.60/\$37,761 times \$4,000, or \$2,779.97; and the exclusion allocable to the interest of C is \$11,517.40/\$37,761 times \$4,000, or \$1,220.03. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

§ 1.101-3 INTEREST PAYMENTS.—(a) *Applicability of section 101(c).*—Section 101(c) provides that if any amount excluded from gross income by section 101(a) (relating to life insurance proceeds) or section 101(b) (relating to employees' death benefits) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income. This provision applies to payments made (either by an insurer or by or on behalf of an employer) of interest earned on any amount so excluded from gross income which is held without substantial diminution of the principal amount during the period when such interest payments are being made or credited to the beneficiaries or estate of the insured or the employee. For example, if a monthly payment is \$100, of which \$99 represents interest and \$1 represents diminution of the principal amount, the principal amount shall be considered held under an agreement to pay interest thereon and the interest payment shall be included in the gross income of the recipient. Section 101(c) applies whether the election to have an amount held under an agreement to pay interest thereon is made by the insured or employee or by his beneficiaries or estate, and whether or not an interest rate is explicitly stated in the agreement. Section 101(d), relating to the payment of life insurance proceeds at a date later than death, shall not apply to any amount to which section 101(c) applies. See section 101(d)(4).

(b) *Determination of "present value".*—For the purpose of determining whether section 101(c) or section 101(d) applies, the present value (at the time of the insured's death) of any amount which is to

be paid at a date later than death shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the size of the payments to be made.

§ 1.101-4 PAYMENT OF LIFE INSURANCE PROCEEDS AT A DATE LATER THAN DEATH.—(a) *In general*.—(1) (i) Section 101(d) states the provisions governing the exclusion from gross income of amounts (other than those to which section 101(c) applies) received under a life insurance contract and paid by reason of the death of the insured which are paid to a beneficiary on a date or dates later than the death of the insured. However, if the amounts payable as proceeds of life insurance to which section 101(a) (1) applies cannot in any event exceed the amount payable at the time of the insured's death, such amounts are fully excludable from the gross income of the recipient (or recipients) without regard to the actual time of payment and no further determination need be made under this section. Section 101(d) (1) (A) provides an exclusion from gross income of any amount determined by a proration, under applicable regulations, of "an amount held by an insurer with respect to any beneficiary". The quoted phrase is defined in section 101(d) (2). For the regulations governing the method of computation of this proration, see paragraphs (c) through (f) of this section. The prorated amounts are to be excluded from the gross income of the beneficiary regardless of the taxable year in which they are actually received (see example (2) of subparagraph (2) of this paragraph).

(ii) Section 101(d) (1) (B) provides an additional exclusion where life insurance proceeds are paid to the surviving spouse of an insured. For purposes of this exclusion, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated, but not under a decree of absolute divorce (section 101(d) (3)). To the extent that the total payments, under one or more agreements, made in excess of the amounts determined by proration under section 101(d) (1) (A) do not exceed \$1,000 in the taxable year of receipt, they shall be excluded from the gross income of the surviving spouse (whether or not payment of any part of such amounts is guaranteed by the insurer). Amounts excludable under section 101(d) (1) (B) are not "prorated" amounts.

(2) The principles of this paragraph may be illustrated by the following examples

*Example (1).* A surviving spouse elects to receive all of the life insurance proceeds with respect to one insured, amounting to \$150,000, in ten annual installments of \$16,500 each, based on a certain guaranteed interest rate. The prorated amount is \$15,000 ( $\$150,000 \div 10$ ). As the second payment, the insurer pays \$17,850, which exceeds the guaranteed payment by \$1,350 as the result of earnings of the insurer in excess of those required to pay the guaranteed installments. The surviving spouse shall include \$1,850 in gross income and exclude \$16,000—determined in the following manner:

Fixed payment (including guaranteed interest) .....	\$16,500
Excess interest .....	1,350
Total payment .....	\$17,850

Prorated amount .....	15,000
Excess over prorated amount .....	\$2,850
Annual excess over prorated amount excludable under section 101-(d) (1) (B) .....	1,000
Amount includible in gross income .....	\$1,850

*Example (2).* Assume the same facts as in example (1), except that the third and fourth annual installments, totalling \$33,000 ( $2 \times \$16,500$ ), are received in a single subsequent taxable year of the surviving spouse. The prorated amount of \$15,000 of each annual installment, totalling \$30,000, shall be excluded even though the spouse receives more than one annual installment in the single subsequent taxable year. However, the surviving spouse is entitled to only one exclusion of \$1,000 under section 101(d) (1) (B) for each taxable year of receipt. The surviving spouse shall include 2,000 in her gross income for the taxable year with respect to the above installment payments (\$33,000 less the sum of \$30,000 plus \$1,000).

*Example (3).* Assume the same facts as in example (1), except that the surviving spouse dies before receiving all ten annual installments and the remaining installments are paid to her estate or beneficiary. In such a case, \$15,000 of each installment would continue to be excludable from the gross income of the recipient, but any amounts received in excess thereof would be fully includible.

(b) *Amount held by an insurer.*—(1) For the purpose of the proration referred to in section 101(d) (1), an “amount held by an insurer with respect to any beneficiary” means an amount equal to the present value to such beneficiary (as of the date of death of the insured) of an agreement by the insurer under a life insurance policy (whether as an option or otherwise) to pay such beneficiary an amount or amounts at a date or dates later than the death of the insured (section 101(d) (2)). The present value of such agreement is to be computed as if the agreement under the life insurance policy had been entered into on the date of death of the insured, except that such value shall be determined by the use of the mortality table and interest rate used by the insurer in calculating payments to be made to the beneficiary under such agreement. Where an insurance policy provides an option for the payment of a specific amount upon the death of the insured in full discharge of the contract, such lump sum is the amount held by the insurer with respect to all beneficiaries (or their beneficiaries) under the contract. See, however, paragraph (e) of this section.

(2) In the case of two or more beneficiaries, the “amount held by the insurer” with respect to each beneficiary depends on the relationship of the different benefits payable to such beneficiaries. Where the amounts payable to two or more beneficiaries are independent of each other, the “amount held by the insurer with respect to each beneficiary” shall be determined and prorated over the periods involved independently. Thus, if a certain amount per month is to be paid to A for his life, and, concurrently, another amount per month is to be paid to B for his life, the “amount held by the insurer” shall be determined and prorated for both A and B independently, but the aggregate shall not exceed the total present value of such payments

to both. On the other hand, if the obligation to pay B was contingent on his surviving A, the "amount held by the insurer" shall be considered an amount held with respect to both beneficiaries simultaneously. Furthermore, it is immaterial whether B is a named beneficiary or merely the ultimate recipient of payments for a term of years. For the special rules governing the computation of the proration of the "amount held by an insurer" in determining amounts excludable under the provisions of section 101(d), see paragraphs (c) to (f), inclusive, of this section.

(3) Notwithstanding any other provision of this section, if the policy was transferred for a valuable consideration, the total "amount held by an insurer" cannot exceed the sum of the consideration paid plus any premiums or other consideration paid subsequent to the transfer if the provisions of section 101(a)(2) and paragraph (b) of § 1.101-1 limit the excludability of the proceeds to such total.

(c) *Treatment of payments for life to a sole beneficiary.*—If the contract provides for the payment of a specified lump sum, but, pursuant to an agreement between the beneficiary and the insurer, payments are to be made during the life of the beneficiary in lieu of such lump sum, the lump sum shall be divided by the life expectancy of the beneficiary determined in accordance with the mortality table used by the insurer in determining the benefits to be paid. However, if payments are to be made to the estate or beneficiary of the primary beneficiary in the event that the primary beneficiary dies before receiving a certain number of payments or a specified total amount, such lump sum shall be reduced by the present value (at the time of the insured's death) of amounts which may be paid by reason of the guarantee, in accordance with the provisions of paragraph (e) of this section, before making this calculation. To the extent that payments received in each taxable year do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" and are excludable from the gross income of the beneficiary without regard to whether he lives beyond the life expectancy used in making the calculation. If the contract in question does not provide for the payment of a specific lump sum upon the death of the insured as one of the alternative methods of payment, the present value (at the time of the death of the insured) of the payments to be made the beneficiary, determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid, shall be used in the above calculation in lieu of a lump sum.

(d) *Treatment of payments to two or more beneficiaries.*—(1) *Unrelated payments.*—If payments are to be made to two or more beneficiaries, but the payments to be made to each are to be made without regard to whether or not payments are made or continue to be made to the other beneficiaries, the present value (at the time of the insured's death) of such payments to each beneficiary shall be determined independently for each such beneficiary. The present value so determined shall then be divided by the term for which the payments are to be made. If the payments are to be made for the life of the beneficiary, the divisor shall be the life expectancy of the beneficiary. To the extent that payments received by a beneficiary do not exceed the

amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether he lives beyond any life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of a beneficiary shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If payments are to be made to the estate or beneficiary of a primary beneficiary in the event that such beneficiary dies before receiving a certain number of payments or a specified total amount, the "present value" of payments to such a beneficiary shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(2) *Related payments.*—If payments to be made to two or more beneficiaries are in the nature of a joint and survivor annuity (as described in paragraph (b) of § 1.72-5), the present value (at the time of the insured's death) of the payments to be made to all such beneficiaries shall be divided by the life expectancy of such beneficiaries as a group. To the extent that the payments received by a beneficiary do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether all the beneficiaries involved live beyond the life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of all the beneficiaries as a group shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If the contract provides that certain payments are to be made in the event that all the beneficiaries of the group die before a specified number of payments or a specified total amount is received by them, the present value of payments to be made to the group shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(3) *Payments to secondary beneficiaries.*—Payments made by reason of the death of a beneficiary (or beneficiaries) under a contract providing that such payments shall be made in the event that the beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount shall be excluded from the gross income of the recipient to the extent that such payments are made solely by reason of such guarantee.

(e) *Treatment of present value of guaranteed payments.*—In the case of payments which are to be made for a life or lives under a contract providing that further amounts shall be paid upon the death of the primary beneficiary (or beneficiaries) in the event that such beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount, the present value (at the time of the insured's death) of all payments to be made under the contract shall not include, for purposes of prorating the amount held



by the insurer, the present value of the payments which may be made to the estate or beneficiary of the primary beneficiary. In such a case, any lump sum amount used to measure the value of the amount held by an insurer with respect to the primary beneficiary must be reduced by the value at the time of the insured's death of any amounts which may be paid by reason of the guarantee provided for a secondary beneficiary or the estate of the primary beneficiary before prorating such lump sum over the life or lives of the primary beneficiaries. Such present value (of the guaranteed payments) shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the benefits to be paid.

(f) *Treatment of payments not paid periodically.*—Payments made to beneficiaries other than periodically shall be included in the gross income of the recipients, but only to the extent that they exceed amounts payable at the time of the death of the insured to each such beneficiary or, where no such amounts are specified, the present value of such payments at that time.

(g) *Examples.*—The principles of this section may be illustrated by the following examples

*Example (1).* A life insurance policy provides for the payment of \$20,000 in a lump sum to the beneficiary at the death of the insured. Upon the death of the insured, the beneficiary elects an option to leave the proceeds with the company for five years and then receive payment of \$24,000, having no claim of right to any part of such sum before the entire five years have passed. Upon the payment of the larger sum, \$24,000, the beneficiary shall include \$4,000 in gross income and exclude \$20,000 therefrom. If it is assumed that the same insurer has determined the benefits to be paid, the same result would obtain if no lump sum amount were provided for at the death of the insured and the beneficiary were to be paid \$24,000 five years later. In neither of these cases would the surviving spouse be able to exclude any additional amount from gross income since both cases involve an amount held by an insurer under an agreement to pay interest thereon to which section 101(c) applies, rather than an amount to be paid periodically after the death of the insured to which section 101(d) applies.

*Example (2).* A life insurance policy provides that \$1,200 per year shall be paid the sole beneficiary (other than a surviving spouse) until a fund of \$20,000 and interest which accrues on the remaining balance is exhausted. A guaranteed rate of interest is specified, but excess interest may be credited according to the earnings of the insurer. Assuming that the fund will be exhausted in 20 years if only the guaranteed interest is actually credited, the beneficiary shall exclude \$1,000 of each installment received (\$20,000 divided by 20) and any installments received, whether by the beneficiary or his estate or beneficiary, in excess of 20 shall be fully included in the gross income of the recipient. If, instead, the excess interest were to be paid each year, any portion of each installment representing an excess over \$1,000 would be fully includible in the recipient's gross income. Thus, if an installment of \$1,350 were received, \$350 of it would be included in gross income.

*Example (3).* Assume that the sole life insurance policy of a de-

cedent provides only for the payment of \$5,000 per year for the life of his surviving spouse, beginning with the insured's death. If the present value of the proceeds, determined by reference to the interest rate and the mortality table used by the insurance company, is \$60,000, and such beneficiary's life expectancy is 20 years, \$3,000 of each \$5,000 payment (\$60,000 divided by 20) is excludable as the prorated portion of the "amount held by an insurer". For each taxable year in which a payment is made, an additional \$1,000 is excludable from the gross income of the surviving spouse. Hence, if she receives only one \$5,000 payment in her taxable year, only \$1,000 is includible in her gross income in that year with respect to such payment (\$5,000 less the total amount excludable, \$4,000). Assuming that the policy also provides for payments of \$2,000 per year for 10 years to the daughter of the insured, the present value of the payments to the daughter is to be computed separately for the purpose of determining the excludable portion of each payment to her. Assuming that such present value is \$15,000, \$1,500 of each payment of \$2,000 received by the daughter is excludable from her gross income (\$15,000 divided by 10). The remaining \$500 shall be included in gross income of the daughter.

*Example (4).* Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of \$1,800 for each of their respective lives upon the death of the insured. The contract does not provide for payments to be made in any other manner. Assuming that the present value of the payments to be made to A, whose life expectancy according to the insurer's mortality table is 30 years, is \$36,000, A shall exclude \$1,200 of each payment received (\$36,000 divided by 30). Assuming that the present value of the payments to be made to B, whose life expectancy according to the insurer's mortality table is 20 years, is \$27,000, B shall exclude \$1,350 of each payment received (\$27,000 divided by 20).

*Example (5).* A life insurance policy provides for the payment of \$76,500 in a lump sum to the beneficiary, A, at the death of the insured. Upon the insured's death, however, A selects an option for the payment of \$2,000 per year for her life and for the same amount to be paid after her death to B, her daughter, for her life. Assuming that since A is 51 years of age and her daughter is 28 years of age, the insurer determined the amount of the payments by reference to a mortality table under which the life expectancy for the lives of both A and B, joint and survivor, is 51 years, \$1,500 of each \$2,000 payment to either A or B (\$76,500 divided by 51, or \$1,500) shall be excluded from the gross income of the recipient. However, if A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude the entire payment of \$2,000 in any taxable year in which she receives but one such payment because of the additional exclusion under section 101(d)(1)(B).

*Example (6).* Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of \$1,800 for each of their respective lives upon the death of the insured, but after the death of either, the survivor is to receive the payments formerly made to the deceased beneficiary until the survivor dies.

Assuming that the life expectancy, joint and survivor, of A and B in accordance with the mortality table used by the insurer is 32 years and assuming that the total present value of the benefits to both (determined in accordance with the interest rate used by the insurer), is \$80,000, A and B shall each exclude \$1,250 of each installment of \$1,800 (\$80,000 divided by the life expectancy, 32, multiplied by the fraction of the annual payment payable to each, one-half) until the death of either. Thereafter, the survivor shall exclude \$2,500 of each installment of \$3,600 (\$80,000 divided by 32).

*Example (7).* A life insurance policy provides for the payment of \$75,000 in a lump sum to the beneficiary, A, at the death of the insured. A, upon the insured's death, however, selects an option for the payment of \$4,000 per year for life, with a guarantee that any part of the \$75,000 lump sum not paid to A before his death shall be paid to B (or his estate), A's beneficiary. Assuming that, under the criteria used by the insurer in determining the benefits to be paid, the present value of the guaranteed amount to B is \$13,500 and that A's life expectancy is 25 years, the lump sum shall be reduced by the present value of the guarantee to B (\$75,000 less \$13,500, or \$61,500) and divided by A's life expectancy (\$61,500 divided by 25, or \$2,460). Hence, \$2,460 of each \$4,000 payment is excludable from A's gross income. If A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude \$3,460 of each \$4,000 payment from gross income in any taxable year in which but one such payment is received. Under these facts, if any amount is paid to B by reason of the fact that A dies before receiving a total of \$75,000, the residue of the lump sum paid to B shall be excluded from B's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary, and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d) (3) of this section).

*Example (8).* Assume that an insurance policy does not provide for the payment of a lump sum, but provides for the payment of \$1,200 per year for a beneficiary's life upon the death of the insured, and also provides that if ten payments are not made to the beneficiary before death a secondary beneficiary (whether named by the insured or by the first beneficiary) shall receive the remainder of the ten payments in similar installments. If, according to the criteria used by the insurance company in determining the benefits, the present value of the payments to the first beneficiary is \$12,000 and the life expectancy of such beneficiary is 15 years, \$800 of each payment received by the first beneficiary is excludable from gross income. Assuming that the same figures obtain even though the payments are to be made at the rate of \$100 per month, the yearly exclusion remains the same unless more or less than twelve months' installments are received by the beneficiary in a particular taxable year. In such a case two-thirds of the total received in the particular taxable year with respect to such beneficiary shall be excluded from gross income. Under either of the above alternatives, any amount received by the second beneficiary by reason of the guarantee of ten payments is

fully excludable from the beneficiary's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d) (3) of this section).

(h) *Limitations on application of section 101(d).*—Section 101(d) shall not apply to interest payments on any amount held by an insurer under an agreement to pay interest thereon. See sections 101(c) and 101(d) (4), and § 1.101-3. See also paragraph (b) (3) of this section for a limitation on the amount which shall be considered an "amount held by an insurer" in the case of proceeds of life insurance which are paid subsequent to the transfer of the policy for a valuable consideration.

§ 1.101-5 ALIMONY, ETC., PAYMENTS.—Proceeds of life insurance policies paid by reason of the death of the insured to his separated wife, or payments excludable as death benefits under section 101(b) paid to a deceased employee's separated wife, if paid to discharge legal obligations imposed by a decree of divorce or separate maintenance, by a written separation agreement executed after August 16, 1954, or by a decree of support entered after March 1, 1954, shall be included in the gross income of the separated wife if section 71 or 682 is applicable to the payments made. For definition of "wife", see section 7701(a) (17) and the regulations thereunder.

§ 1.101-6 EFFECTIVE DATE.—(a) The provisions of section 101 and §§ 1.101-1, 1.101-2, 1.101-3, 1.101-4, and 1.101-5 are applicable only with respect to amounts received by reason of the death of an insured or an employee occurring after August 16, 1954. In the case of such amounts, these sections are applicable even though the receipt of such amounts occurred in a taxable year beginning before January 1, 1954, to which the Internal Revenue Code of 1939 applies.

(b) Section 22(b) (1) of the Internal Revenue Code of 1939 and the regulations pertaining thereto shall apply to amounts received by reason of the death of an insured or an employee occurring before August 17, 1954, regardless of the date of receipt.

## § 1.107 STATUTORY PROVISIONS; RENTAL VALUE OF PARSONAGES.

### SEC. 107. RENTAL VALUE OF PARSONAGES.

In the case of a minister of the gospel, gross income does not include—

(1) the rental value of a home furnished to him as part of his compensation; or

(2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

§ 1.107-1 RENTAL VALUE OF PARSONAGES.—(a) In the case of a minister of the gospel, gross income does not include (1) the rental value of a home, including utilities, furnished to him as a part of his compensation, or (2) the rental allowance paid to him as part of his compensation, to the extent such allowance is used by him to rent or otherwise provide a home. In order to qualify for the exclusion, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel. In general, the rules provided in § 1.1402(c)-1(e) will be applicable

to such determination. Examples of specific services the performance of which will be considered duties of a minister for purposes of section 107 include the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries. Also, the service performed by a qualified minister as an employee of the United States (other than as a chaplain in the Armed Forces, whose service is considered to be that of a commissioned officer in his capacity as such, and not as a minister in the exercise of his ministry), or a State, Territory, or possession of the United States, or a political subdivision of any of the foregoing, or the District of Columbia, is in the exercise of his ministry provided the service performed includes such services as are ordinarily the duties of a minister.

(b) For purposes of section 107, the term "home" means a dwelling place (including furnishings) and the appurtenances thereto, such as a garage. The term "rental allowance" means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken prior to January 1, 1958, by the employing church or other qualified organization, or if such amount is designated as rental allowance pursuant to official action taken in advance of such payment by the employing church or other qualified organization when paid after December 31, 1957. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. The designation referred to in this paragraph is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration.

(c) A rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home. Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home. Where the minister rents, purchases, or owns a farm or other business property in addition to a home, the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.

#### STANDARD DEDUCTION FOR INDIVIDUALS

#### § 1.141 STATUTORY PROVISIONS; STANDARD DEDUCTION.

#### SEC. 141. STANDARD DEDUCTION.

The standard deduction referred to in section 63(b) (defining taxable income in case of individual electing standard deduction) shall be an amount equal to 10 percent of the adjusted gross income or \$1,000, which-

#### § 1.107-1(b)

ever is the lesser, except that in the case of a separate return by a married individual the standard deduction shall not exceed \$500.

§ 1.141-1 STANDARD DEDUCTION.—(a) The taxpayer may elect to take, in addition to the deductions from gross income allowable in computing adjusted gross income and the deduction described in section 151, relating to personal exemptions, a standard deduction in lieu of all nonbusiness deductions (that is, deductions other than those described in section 62) and in lieu of certain credits allowable to the taxpayer, had he not so elected. See section 36. Such credits include: The credit provided by section 33 for taxes imposed by foreign countries and possessions of the United States; the credit provided by section 32 for tax withheld at source under section 1451 by the obligor on tax-free covenant bonds with respect to interest on such bonds; and the credit provided by section 35 with respect to interest on United States obligations and interest on obligations of instrumentalities of the United States.

(b) In the case of a joint return, there is only one adjusted gross income and only one standard deduction. For example, if a husband has an income of \$15,000 and his spouse has an income of \$12,000 for the taxable year for which they file a joint return, and they have no deductions allowable for the purpose of computing adjusted gross income, the adjusted gross income is \$27,000, and the standard deduction is \$1,000 (and not \$2,000).

(c) In the case of taxpayers whose adjusted gross income is \$5,000 or more, the standard deduction is \$1,000 or 10 percent of adjusted gross income, whichever is the lesser, except that in the case of a separate return by a married individual the standard deduction is \$500. For determination of marital status see § 1.143-1.

(d) In the case of taxpayers whose adjusted gross income is less than \$5,000, the table provided in section 3 has incorporated a standard deduction of about 10 percent of the adjusted gross income upon which the tax is determined.

(e) An election to take the standard deduction may be made for a taxable year which is less than 12 months on account of the death of the taxpayer.

## § 1.142 STATUTORY PROVISIONS; INDIVIDUALS NOT ELIGIBLE FOR STANDARD DEDUCTION.

### SEC. 142. INDIVIDUALS NOT ELIGIBLE FOR STANDARD DEDUCTION.

(a) HUSBAND AND WIFE.—The standard deduction shall not be allowed to a husband or wife if the tax of the other spouse is determined under section 1 on the basis of the taxable income computed without regard to the standard deduction.

(b) CERTAIN OTHER TAXPAYERS INELIGIBLE.—The standard deduction shall not be allowed in computing the taxable income of—

- (1) a nonresident alien individual;
- (2) a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);
- (3) an individual making a return under section 443(a)(1) for a period of less than 12 months on account of a change in his annual accounting period; or
- (4) an estate or trust, common trust fund, or partnership.

§ 1.142-1 HUSBAND AND WIFE.—(a) In the case of husband and wife, if the tax of one spouse is determined under section 1 or 1201 on the basis of the taxable income computed without regard to the standard deduction, the other spouse may not elect to take the standard deduction. If a joint return is filed and election made thereon to take the standard deduction, such deduction shall be determined by reference to the aggregate adjusted gross income of both spouses. If Form 1040A is filed as a combined return, the standard deduction is allowed through the use of the tax table in section 3. See the regulations under section 6014, limiting the use of Form 1040A as a combined return to cases in which the aggregate adjusted gross income of the spouses is less than \$5,000.

(b) If each spouse files a separate Form 1040, both must elect to take the standard deduction or both are denied the standard deduction. If one spouse files Form 1040 and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, hence, may not file Form 1040A as his or her return. Thus, if A and his wife B have adjusted gross incomes of \$6,000 and \$3,500, respectively, from wages subject to withholding and A files Form 1040 and does not elect thereon to take the standard deduction, B may not file Form 1040A but must file Form 1040, taking thereon only her actual allowable deductions and not the standard deduction. In such case, however, if both elect to take the standard deduction, A must file Form 1040, but B may file Form 1040A or, in the alternative, she may file Form 1040 and compute the tax under section 3. Under either alternative, effect is given to the standard deduction through the application of section 3.

(c) The restriction upon the right of a married person to elect the standard deduction in his separate return is applicable with respect to the taxable years of the husband and wife ending in the same calendar year, except that in the event of the death of one spouse the restriction is applicable with respect to the taxable year ended with death and the taxable year of the surviving spouse in which such death occurs. The restriction applies unless the spouses are legally separated under a decree of divorce or separate maintenance. For determination of marital status, see § 1.143-1.

§ 1.142-2 STANDARD DEDUCTION NOT ALLOWABLE.—The standard deduction is not allowable in the case of—

(a) A nonresident alien individual (including one who enters and leaves the United States at frequent intervals);

(b) A citizen of the United States entitled to the benefits of section 931;

(c) A taxable year of less than 12 months where such taxable year arises because of a change in accounting period under section 443(a) (1); or

(d) An estate or trust, common trust fund, or partnership.

§ 1.143 STATUTORY PROVISIONS; DETERMINATION OF MARITAL STATUS.

#### SEC. 143. DETERMINATION OF MARITAL STATUS.

For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies

§ 1.142-1(a)

during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

§ 1.143-1 DETERMINATION OF MARITAL STATUS.—The determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. The provisions of this section may be illustrated by the following examples:

*Example (1).* Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1954 they enter into a separation agreement and thereafter live apart, but no decree of divorce or separate maintenance is issued until March 1955. If A itemizes and claims his actual deductions on his return for the calendar year 1954, B may not elect the standard deduction on her return since B is considered as married to A (although permanently separated by agreement) on the last day of 1954.

*Example (2).* Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1954. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1954 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

## § 1.144 STATUTORY PROVISIONS; ELECTION OF STANDARD DEDUCTION.

### SEC. 144. ELECTION OF STANDARD DEDUCTION.

#### (a) METHOD AND EFFECT OF ELECTION.—

(1) If the adjusted gross income shown on the return is \$5,000 or more, the standard deduction shall be allowed if the taxpayer so elects in his return, and the Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the adjusted gross income shown on the return is \$5,000 or more, but the correct adjusted gross income is less than \$5,000, then an election by the taxpayer under the preceding sentence to take the standard deduction shall be considered as his election to pay the tax imposed by section 3 (relating to tax based on tax table); and his failure to make under the preceding sentence an election to take the standard deduction shall be considered his election not to pay the tax imposed by section 3.

(2) If the adjusted gross income shown on the return is less than \$5,000, the standard deduction shall be allowed only if the taxpayer elects, in the manner provided in section 4, to pay the tax imposed by section 3. If the adjusted gross income shown on the return is less than \$5,000, but the correct adjusted gross income is \$5,000 or more, then an election by the taxpayer to pay the tax imposed by section 3 shall be considered as his election to take the standard deduction; and his failure to elect to pay the tax imposed by section 3 shall be considered his election not to take the standard deduction.

(3) If the taxpayer on making his return fails to signify, in the manner provided by paragraph (1) or (2), his election to take the standard deduction or to pay the tax imposed by section 3, as the case may be, such failure shall be considered his election not to take the standard deduction.



(b) **CHANGE OF ELECTION.**—Under regulations prescribed by the Secretary or his delegate, a change of an election for any taxable year to take, or not to take, the standard deduction, or to pay, or not to pay, the tax under section 3, may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding, for purposes of section 142 (a), to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(1) the spouse makes a change of election with respect to the standard deduction for the taxable year covered in such separate return, consistent with the change of election sought by the taxpayer, and

(2) the taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed on with the Secretary or his delegate, of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This subsection shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding (for purposes of section 142 (a)) to the taxable year of the taxpayer, has been compromised under section 7122.

§ 1.144-1 **MANNER AND EFFECT OF ELECTION TO TAKE THE STANDARD DEDUCTION.**—The following rules are prescribed with respect to the manner of signifying an election by a taxpayer to take the standard deduction:

(a) A taxpayer whose adjusted gross income as shown by his return is \$5,000 or more shall be allowed the standard deduction if he signifies on his return his election to take such deduction. Such taxpayer shall so signify on his return by claiming thereon the deduction in the amount provided for in section 141 instead of itemizing the deductions allowable in computing taxable income, other than those specified in sections 62 and 151. The amount to be claimed on the return by such taxpayer is \$1,000 or 10 percent of the adjusted gross income, whichever is lesser (except that in the case of a separate return by a married individual with an adjusted gross income of \$5,000 or more, the amount is \$500). If in any case the adjusted gross income shown on the return of the taxpayer is \$5,000 or more, but the correct adjusted gross income is less than \$5,000, then:

(1) If the taxpayer has elected on his return to take the standard deduction, such election shall be deemed to be an election by the taxpayer to pay the tax imposed by section 3; and

(2) If the taxpayer has not so elected upon his return, it shall be deemed that the taxpayer has elected not to pay the tax under section 3.

(b) If the adjusted gross income shown on the return is less than \$5,000, the standard deduction is allowable if the taxpayer elects to pay the tax imposed by section 3. As to the manner and effect of election to pay the tax under section 3, see § 1.4-2. In the case of a taxpayer who files Form 1040, he shall signify his election to pay the tax imposed by section 3 by showing on Form 1040 as his tax the amount computed by use of the tax table in section 3. In any case, however, in which adjusted gross income shown on the return is less than \$5,000, but the correct adjusted gross income is in fact \$5,000 or more, then:

(1) If the taxpayer has elected to pay the tax imposed under

section 3, it shall be deemed that he has elected to take the standard deduction; and

(2) If the taxpayer has not elected on his return to pay the tax under section 3, it shall be deemed that he has made an election not to take the standard deduction.

A taxpayer having adjusted gross income of less than \$5,000, who does not elect to pay the tax imposed by section 3, may not take the standard deduction.

§ 1.144-2 CHANGE OF ELECTION TO TAKE, OR NOT TO TAKE, THE STANDARD DEDUCTION.—(a) A change of the election to take, or not to take, the standard deduction for any taxable year may be made before or after the time prescribed for filing the return for the taxable year. However, the period of time prescribed in section 6511 within which claim for credit or refund of tax must be made is not extended by the right to effect a change of election.

(b) If the spouse of the taxpayer filed a separate return for any taxable year that corresponds, for the purpose of section 142(a), to the taxable year of the taxpayer, a change of election may not be made by the taxpayer unless: (1) The spouse makes a change of election in such separate return with respect to the standard deduction consistent with the change of election sought by the taxpayer, and (2) the taxpayer and his spouse file a consent in writing to the assessment, within such period of time as may be agreed upon, of any deficiency of either to the extent attributable to such change of election even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(c) A change of election for any taxable year shall not be permitted if the tax liability of the taxpayer for the taxable year, or of the taxpayer's spouse for the taxable year corresponding, for the purpose of section 142 (a), to the taxable year of the taxpayer, has been compromised under the provisions of section 7122.

## § 1.145 STATUTORY PROVISIONS; CROSS REFERENCE.

### SEC. 145. CROSS REFERENCE.

For disallowance of certain credits against the tax in the case of individuals electing the standard deduction, see section 36.

## § 1.151 STATUTORY PROVISIONS; ALLOWANCE OF DEDUCTIONS FOR PERSONAL EXEMPTIONS.

### SEC. 151. ALLOWANCE OF DEDUCTIONS FOR PERSONAL EXEMPTIONS.

(a) ALLOWANCE OF DEDUCTIONS.—In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) TAXPAYER AND SPOUSE.—An exemption of \$600 for the taxpayer; and an additional exemption of \$600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(c) ADDITIONAL EXEMPTION FOR TAXPAYER OR SPOUSE AGED 65 OR MORE.—

(1) FOR TAXPAYER.—An additional exemption of \$600 for the taxpayer if he has attained the age of 65 before the close of his taxable year.

(2) **FOR SPOUSE.**—An additional exemption of \$600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse has attained the age of 65 before the close of such taxable year, and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(d) **ADDITIONAL EXEMPTION FOR BLINDNESS OF TAXPAYER OR SPOUSE.**—

(1) **FOR TAXPAYER.**—An additional exemption of \$600 for the taxpayer if he is blind at the close of his taxable year.

(2) **FOR SPOUSE.**—An additional exemption of \$600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. For purposes of this paragraph, the determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer; except that if the spouse dies during such taxable year such determination shall be made as of the time of such death.

(3) **BLINDNESS DEFINED.**—For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(e) **ADDITIONAL EXEMPTION FOR DEPENDENTS.**—

(1) **IN GENERAL.**—An exemption of \$600 for each dependent (as defined in section 152)—

(A) whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than \$600, or

(B) who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student.

(2) **EXEMPTION DENIED IN CASE OF CERTAIN MARRIED DEPENDENTS.**—No exemption shall be allowed under this subsection for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(3) **CHILD DEFINED.**—For purposes of paragraph (1)(B), the term "child" means an individual who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer.

(4) **STUDENT AND EDUCATIONAL INSTITUTION DEFINED.**—For purposes of paragraph (1)(B)(ii), the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins—

(A) is a full-time student at an educational institution; or

(B) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State.

For purposes of this paragraph, the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on.

§ 1.151-1 **DEDUCTIONS FOR PERSONAL EXEMPTIONS.**—(a) *In general.*—(1) In computing taxable income, an individual is allowed a deduction for the exemptions specified in section 151. Such exemptions are: (i) The exemptions for an individual taxpayer and spouse (the so-called personal exemptions); (ii) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions); (iii) the additional exemptions for a blind taxpayer and a blind spouse; and (iv) the exemptions for dependents of the taxpayer.

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(2) A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under section 1 or 1201(b) is allowed as deductions the exemptions specified in section 151, even though as to the United States such individual is a nonresident alien. See section 876 and the regulations thereunder, relating to alien residents of Puerto Rico.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions).*—Section 151(b) allows an exemption of \$600 for the taxpayer and an additional exemption of \$600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Thus, a husband is not entitled to an exemption for his wife on his separate return for the taxable year beginning in a calendar year during which she has any gross income (though insufficient to require her to file a return). Since, in the case of a joint return, there are two taxpayers (although under section 6013 there is only one income for the two taxpayers on such return, i. e., their aggregate income), two exemptions of \$600 are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no other person is allowed an exemption for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).*—(1) Section 151(c) provides an additional exemption of \$600 for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption of \$600 is also allowed to the taxpayer for his spouse if a separate return is made by the taxpayer and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption of \$600 will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 151(c) are in addition to the exemptions for the taxpayer and spouse under section 151(b).

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth

birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.*—(1) Section 151(d) provides an additional exemption of \$600 for the taxpayer if he is blind at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 151(b) and are also in addition to the exemptions under section 151(c) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has attained the age of 65 before the close of his taxable year and who is blind at the close of his taxable year is entitled, in addition to the so-called personal exemption of \$600, to two further exemptions, each of \$600, one by reason of his age and the other by reason of his blindness. If a husband and wife make a joint return, an exemption of \$600 for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 151(d) for a blind taxpayer and a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or, in the case of a spouse who dies during such taxable year, as of the time of such death), attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

§ 1.151-2 ADDITIONAL EXEMPTIONS FOR DEPENDENTS.—(a) Section 151(e) allows to a taxpayer an exemption of \$600 for each dependent (as defined in section 152) whose gross income (as defined in section 61) for the calendar year in which the taxable year of the taxpayer begins is less than \$600, or who is a child of the taxpayer and who—

(1) Has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or

(2) Is a student, as defined in § 1.151-3(b).

No exemption shall be allowed under section 151(e) for any dependent who has made a joint return with his spouse under section

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6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(b) The only exemption allowed for a dependent of the taxpayer is that provided by section 151(e). The exemptions provided by section 151(c) (old-age exemptions) and section 151(d) (exemptions for the blind) are allowed only for the taxpayer or his spouse. For example, where a taxpayer provides the entire support for his father who meets all the requirements of a dependent, he is entitled to only one exemption of \$600 for his father (section 151(e)), even though his father is over the age of 65.

§ 1.151-3 DEFINITIONS.—(a) *Child*.—For purposes of sections 151(e), 152, and the regulations thereunder, the term “child” means a son, stepson, daughter, stepdaughter, adopted son, or adopted daughter of the taxpayer.

(b) *Student*.—For purposes of section 151(e) and section 152(d), and the regulations thereunder, the term “student” means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. An example of “institutional on-farm training” is that authorized by the Veterans’ Readjustment Assistance Act of 1952, as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours or courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(c) *Educational institution*.—For purposes of sections 151(e) and 152, and the regulations thereunder, the term “educational institution” means a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges, universities, normal schools, technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth.

## § 1.152 STATUTORY PROVISIONS; DEPENDENT DEFINED.

### SEC. 152. DEPENDENT DEFINED.

(a) GENERAL DEFINITION.—For purposes of this subtitle, the term “dependent” means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer (or is treated under subsection (c) as received from the taxpayer):

- (1) A son or daughter of the taxpayer, or a descendant of either,
- (2) A stepson or stepdaughter of the taxpayer,
- (3) A brother, sister, stepbrother, or stepsister of the taxpayer,
- (4) The father or mother of the taxpayer, or an ancestor of either,
- (5) A stepfather or stepmother of the taxpayer,
- (6) A son or daughter of a brother or sister of the taxpayer,

- (7) A brother or sister of the father or mother of the taxpayer,
- (8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer,
- (9) An individual who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, or

(10) An individual who—

(A) Is a descendant of a brother or sister of the father or mother of the taxpayer,

(B) For the taxable year of the taxpayer receives institutional care required by reason of a physical or mental disability, and

(C) Before receiving such institutional care, was a member of the same household as the taxpayer.

(b) RULES RELATING TO GENERAL DEFINITION.—For purposes of this section—

(1) The terms “brother” and “sister” include a brother or sister by the halfblood.

(2) In determining whether any of the relationships specified in subsection (a) or paragraph (1) of this subsection exists, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) The term “dependent” does not include any individual who is not a citizen of the United States unless such individual is a resident of the United States, of a country contiguous to the United States, of the Canal Zone, or of the Republic of Panama. The preceding sentence shall not exclude from the definition of “dependent” any child of the taxpayer born to him, or legally adopted by him, in the Philippine Islands before January 1, 1956, if the child is a resident of the Republic of the Philippines, and if the taxpayer was a member of the Armed Forces of the United States at the time the child was born to him or legally adopted by him.

(4) A payment to a wife which is includible in the gross income of the wife under section 71 or 682 shall not be treated as a payment by her husband for the support of any dependent.

(c) MULTIPLE SUPPORT AGREEMENTS.—For purposes of subsection (a), over half of the support of an individual for a calendar year shall be treated as received from the taxpayer if—

(1) No one person contributed over half of such support;

(2) Over half of such support was received from persons each of whom, but for the fact that he did not contribute over half of such support, would have been entitled to claim such individual as a dependent for a taxable year beginning in such calendar year;

(3) The taxpayer contributed over 10 percent of such support; and

(4) Each person described in paragraph (2) (other than the taxpayer) who contributed over 10 percent of such support files a written declaration (in such manner and form as the Secretary or his delegate may by regulations prescribe) that he will not claim such individual as a dependent for any taxable year beginning in such calendar year.

(d) SPECIAL SUPPORT TEST IN CASE OF STUDENTS.—For purposes of subsection (a), in the case of any individual who is—

(1) A son, stepson, daughter, or stepdaughter of the taxpayer (within the meaning of this section), and

(2) A student

(within the meaning of section 151(e)(4)),

amounts received as scholarships for study at an educational institution (as defined in section 151(e)(4)) shall not be taken into account in determining whether such individual received more than half of his support from the taxpayer.

[Sec. 152 as amended by sec. 2, P.L. 333 (84th Cong.)].

§ 1.152-1 GENERAL DEFINITION OF A DEPENDENT.—(a) (1) For purposes of the income taxes imposed on individuals by the Internal Revenue Code of 1954, the term “dependent” means any individual described in paragraphs (1) through (10) of section 152(a) over

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half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer.

(2) (i) For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Generally, these items of support are measured in terms of the amount of expense incurred by the one furnishing such items. However, if the item of support furnished an individual (either by himself or others) is in the form of goods, services, or other benefits, it will be necessary to measure the amount of such items of support in terms of its fair market value.

(ii) In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act. For example, a father receives \$800 social security benefits, \$400 interest, and \$1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the social security benefits of \$800 are not includible in the father's gross income does not prevent such an amount from entering into the computation of the total amount contributed for the father's support. Consequently, since the son's contribution of \$1,000 was less than one-half of the father's support (\$2,200) he may not claim his father as a dependent.

(b) Section 152(a) (9) applies to any individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who lives with the taxpayer and is a member of the taxpayer's household during the entire taxable year of the taxpayer. An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law. It is not necessary under section 152(a) (9) that the dependent be related to the taxpayer. For example, foster children and children awaiting adoption may qualify as dependents. It is necessary, however, that the taxpayer both maintain and occupy the household. The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, or vacation shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death. Likewise, the period during the taxable year preceding the birth of an individual shall not prevent such individual from qualifying as a dependent under section 152(a) (9). Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not



be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth, and if such child would otherwise have been a member of the taxpayer's household during such period.

(c) In the case of a child of the taxpayer who is under 19 or who is a student, the taxpayer may claim the dependency exemption for such child provided he has furnished more than one-half of the support of such child for the calendar year in which the taxable year of the taxpayer begins, even though the income of the child for such calendar year may be \$600 or more. In such a case, there may be two exemptions claimed for the child: One on the parent's (or stepparent's) return, and one on the child's return. In determining whether the taxpayer does in fact furnish more than one-half of the support of an individual who is a child, as defined in paragraph (a) of § 1.151-3, of the taxpayer and who is a student, as defined in paragraph (b) of § 1.151-3, a special rule regarding scholarships applies. Amounts received as scholarships, as defined in paragraph (a) of § 1.117-3, for study at an educational institution shall not be considered in determining whether the taxpayer furnishes more than one-half the support of such individual. For example, A has a child who receives a \$1,000 scholarship to the X college for one year. A contributes \$500, which constitutes the balance of the child's support for that year. A may claim the child as a dependent, as the \$1,000 scholarship is not counted in determining the support of the child. For purposes of this paragraph, amounts received for tuition payments and allowances by a veteran under the provisions of the Servicemen's Readjustment Act of 1944 or the Veterans' Readjustment Assistance Act of 1952 are not amounts received as scholarships. See also § 1.117-4. For definition of the terms "child", "student", and "educational institution", as used in this paragraph, see § 1.151-3.

§ 1.152-2 RULES RELATING TO GENERAL DEFINITION OF DEPENDENT.—(a) To qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico at some time during the calendar year in which the taxable year of the taxpayer begins. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956, at a time when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if such resident otherwise qualifies as a dependent. For definition of "Armed Forces of the United States", see section 7701(a)(15).

(b) A payment to a wife which is includible in her gross income under section 71 or section 682 shall not be considered a payment by her husband for the support of any dependent.

(c) A legally adopted child of an individual shall be treated as a child of such individual by blood.

(d) In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a

husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151.

§ 1.152-3 MULTIPLE SUPPORT AGREEMENTS.—(a) Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support of an individual for the calendar year (in cases where two or more taxpayers contributed to the support of such individual) if—

(1) No one person contributed over half of the individual's support,

(2) Each member of the group which collectively contributed more than half of the support of the individual would have been entitled to the dependency exemption but for the fact that he did not contribute more than one-half of such support,

(3) The member of the group claiming the dependency exemption contributed more than 10 percent of the individual's support, and

(4) Each other person in the group who contributed more than 10 percent of such support files a written declaration that he will not claim the dependency exemption for such individual for any taxable year beginning in such calendar year.

(b) Application of the rule contained in paragraph (a) of this section may be illustrated by the following examples:

*Example (1).* Brothers A, B, C, and D contributed the entire support of their mother in 1956 in the following percentages: A, 30 percent; B, 20 percent; C, 29 percent; and D, 21 percent. Any one of the brothers, except for the fact that he did not contribute more than half of her support, would have been entitled to claim his mother as a dependent. Consequently, any one of the brothers could claim a deduction for the exemption of the mother provided a written declaration (as provided in paragraph (c) of this section) from each of the other brothers is attached to his income tax return. Even though A and D together contributed more than one-half the support of the mother, A, if he wished to claim his mother as a dependent, would be required to attach written declarations from B, C, and D to his income tax return, since each of those three contributed more than 10 percent of the support and, but for the support requirement, would have been entitled to claim the dependency exemption.

*Example (2).* E, an individual who resides with his son, received \$1,500 during the calendar year 1956, which constituted his entire support for that year. The source of the \$1,500 was as follows:

Source	Amount received	Percentage of total
Social Security .....	\$375	25
N, an unrelated neighbor .....	165	11
B, a brother .....	210	14
D, a daughter .....	150	10
S, a son .....	600	40
Total received by E .....	\$1,500	100

B, D, and S are persons each of whom, but for the fact that he did not contribute more than half of the \$1,500, could claim E as a dependent for a taxable year beginning in 1956. The three together contributed \$960, or 64 percent of the \$1,500, and, thus, each is a member of the group to be considered for the purpose of section 152(c). B and S are the only members of such group who can meet all the requirements of section 152 (c) and either one could claim E as a dependent for his taxable year beginning in 1956 provided he attached to his income tax return a written declaration (as provided in paragraph (c) of this section) signed by the other, and furnished the other information required by the return with respect to all the contributions to E. Inasmuch as D did not contribute more than 10 percent of E's support, she is not entitled to claim E as a dependent for a taxable year beginning in 1956 nor is she required to file a written declaration with respect to her contributions to E. N contributed over 10 percent of the support of E in 1956 but, since he is an unrelated neighbor, he does not qualify as a member of the group for the purpose of the multiple support agreement under section 152(c).

(c) The member of a group of contributors who claims the dependency deduction for an individual under the multiple support agreement provisions of section 152(c) must attach to his income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the dependency exemption. The written declaration required by this paragraph may be made on Form 2120, which contains a statement of the fact of contribution and a waiver of the claim for dependency exemption. Any declaration made other than on Form 2120 shall conform to the substance of Form 2120. The taxpayer claiming the exemption should be prepared to furnish other information, when required, which will substantiate his right to claim such exemption. Such information may include a statement showing the names of all contributors (whether or not members of the group described in section 152(c)) and the amount contributed by each to the support of the claimed dependent.

## § 1.153 STATUTORY PROVISIONS; DETERMINATION OF MARITAL STATUS.

### SEC. 153. DETERMINATION OF MARITAL STATUS.

For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

§ 1.153-1 DETERMINATION OF MARITAL STATUS.—For the purpose of determining the right of an individual to claim an exemption for his spouse under section 151 (b), the determination of whether such individual is married shall be made as of the close of his taxable year,

### § 1.152-3(c)

unless his spouse dies during such year, in which case the determination shall be made as of the time of such death. An individual legally separated from his spouse under decree of divorce or separate maintenance shall not be considered as married. The provisions of this section may be illustrated by the following examples:

*Example (1).* A, who files his returns on the basis of a calendar year, married B on December 31, 1956. B, who had never previously married, had no gross income for the calendar year 1956 nor was she the dependent of another taxpayer for such year. A may claim an exemption for B for 1956.

*Example (2).* C and his wife, D, were married in 1940. They remained married until July 1956 at which time D was granted a decree of divorce. C, who files his income tax returns on a calendar year basis, cannot claim an exemption for D on his 1956 return as C and D were not married on the last day of C's taxable year. Had D died instead of being divorced, C could have claimed an exemption for D for 1956 as their marital status would have been determined as of the date of D's death.

## § 1.154 STATUTORY PROVISIONS; CROSS REFERENCES.

### SEC. 154. CROSS REFERENCES.

(1) For definitions of "husband" and "wife", as used in section 152(b) (4), see section 7701(a) (17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642(b).

(3) For exemptions of nonresident aliens, see section 873(d).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931 (e).

### ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

## § 1.163 STATUTORY PROVISIONS; ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS; INTEREST.

### SEC. 163. INTEREST.

(a) **GENERAL RULE.**—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) **INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.**—

(1) **GENERAL RULE.**—If personal property is purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained, then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(2) **LIMITATION.**—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) **CROSS REFERENCES.**—

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

§ 1.163-1 INTEREST DEDUCTION IN GENERAL.—(a) Except as otherwise provided in sections 264-267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 583.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

§ 1.163-2 INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.—(a) *In general.*—Whenever there is a contract for the purchase of personal property providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. Section 163(b) contains a formula, described in paragraph (b) of this section, in accordance with which the amount of interest deductible in the taxable year must be computed. This formula is designed to operate automatically in the case of any installment purchase, without regard to whether payments under the contract are made when due or are in default. For applicable limitations when an obligation to pay is terminated, see paragraph (c) of this section.

(b) *Computation.*—The portion of any such payments to be treated as interest shall be equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of this computation, the average unpaid balance under the contract is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

§ 1.163-1(a)

(c) *Limitations.*—The amount treated as interest under section 163(b) and this section for any taxable year shall not exceed the amount of the payments made under the contract during the taxable year nor the aggregate carrying charges properly attributable to each contract for such taxable year. In computing the amount to be treated as interest if the obligation to pay is terminated as, for example, in the case of a repossession of the property, the unpaid balance on the first day of the month during which the obligation is terminated shall be zero.

(d) *Illustrations.*—The provisions of this section may be illustrated by the following examples:

*Example (1).* On January 20, 1955, A purchased a television set for \$400, including a stated carrying charge of \$25. The down payment was \$50, and the balance was paid in 14 monthly installments of \$25 each, on the 20th day of each month commencing with February. Assuming that A is a cash method, calendar year taxpayer and that no other installment purchases were made, the amount to be treated as interest in 1955 is \$12.38, computed as follows:

YEAR 1955

<i>First day of:</i>	<i>Unpaid balance outstanding</i>
January .....	\$0
February .....	350
March .....	325
April .....	300
May .....	275
June .....	250
July .....	225
August .....	200
September .....	175
October .....	150
November .....	125
December .....	100
	\$2,475

Sum of unpaid balances  $\$2,475 \div 12 = \$206.25$ ;  
6% thereof = \$12.38

*Example (2).* On November 20, 1955, B purchased a furniture set for \$1,250, including a stated carrying charge of \$48. The down payment was \$50 and the balance was payable in 12 monthly installments of \$100 each, on the first day of each month commencing with December 1955. Assume that B is a cash method, calendar year taxpayer and that no other installment purchases were made. Assume further that B made the first payment when due, but made only one other payment on June 1, 1956. The amount to be treated as interest in 1955 is \$4, and the amount to be treated as interest in 1956 is \$33, computed as follows:

YEAR 1955

<i>First day of:</i>	<i>Unpaid balance outstanding</i>
December .....	\$1200
	Sum of unpaid balances $\$1200 \div 12 = \$100$
	6% thereof = \$6
	Carrying charges attributable to 1955 = \$4

## YEAR 1956

<i>First day of:</i>	<i>Unpaid balance outstanding</i>
January .....	\$1100
February .....	1000
March .....	900
April .....	800
May .....	700
June .....	600
July .....	500
August .....	400
September .....	300
October .....	200
November .....	100
	<hr/>
	\$6600

Sum of unpaid balances  $\$6600 \div 12 = \$550$

6% thereof = \$33

Carrying charges attributable to 1956 = \$44 ( $\$4 \times 11$ ).

*Example (3).* Assume the same facts as in example (2), except that the furniture was repossessed and B's obligation to pay terminated as of July 15, 1956. The amount to be treated as interest in 1955 is \$4, computed as in example (2) above. The amount to be treated as interest in 1956 is \$25.50, computed as follows:

## YEAR 1956

<i>First day of:</i>	<i>Unpaid balance outstanding</i>
January .....	\$1100
February .....	1000
March .....	900
April .....	800
May .....	700
June .....	600
July–November .....	–0–
	<hr/>
	\$5100

Sum of unpaid balances  $\$5100 \div 12 = \$425$

6% thereof = \$25.50

Carrying charges attributable to 1956 = \$44 ( $\$4 \times 11$ ).

(e) *Effective date.*—The provisions of section 163 are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954. The rule provided in section 163(b) and this section applies to payments made during such taxable years regardless of when the contract of sale was made.

### § 1.164 STATUTORY PROVISIONS; ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS; TAXES.

#### SEC. 164. TAXES.

(a) **GENERAL RULE.**—Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

(b) **DEDUCTION DENIED IN CASE OF CERTAIN TAXES.**—No deduction shall be allowed for the following taxes:

(1) Federal income taxes, including—

(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

### § 1.163–2(e)

(C) the tax withheld at source on wages under section 3402, and corresponding provisions of prior revenue laws.

(2) Federal war profits and excess profits taxes.

(3) Federal import duties, and Federal excise and stamp taxes (not described in paragraph (1), (2), (4), or (5)); but this paragraph shall not prevent such duties and taxes from being deducted under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

(4) Estate, inheritance, legacy, succession, and gift taxes.

(5) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent—

(A) the deduction of so much of such taxes as is properly allocable to maintenance or interest charges; or

(B) the deduction of taxes levied by a special taxing district if—

(i) the district covers the whole of at least one county;

(ii) at least 1,000 persons are subject to the taxes levied by the district; and

(iii) the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

(6) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

(7) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer.

(c) CERTAIN RETAIL SALES TAXES AND GASOLINE TAXES.—

(1) GENERAL RULE.—In the case of any State or local sales tax, if the amount of the tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount shall be allowed as a deduction to the consumer as if it constituted a tax imposed on, and paid by, such consumer.

(2) DEFINITION.—For purposes of paragraph (1), the term "State or local sales tax" means a tax imposed by a State, a Territory, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia, which tax—

(A) is imposed on persons engaged in selling tangible personal property at retail (or on persons selling gasoline or other motor vehicle fuels at wholesale or retail) and is a stated sum per unit of property sold or is measured either by the gross sales price or by the gross receipts from the sale; or

(B) is imposed on persons engaged in furnishing services at retail and is measured by the gross receipts for furnishing such services.

(d) APPOINTMENT OF TAXES ON REAL PROPERTY BETWEEN SELLER AND PURCHASER.—

(1) GENERAL RULE.—For purposes of subsection (a), if real property is sold during any real property tax year, then—

(A) so much of the real property tax as is properly allocable to that part of such year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and

(B) so much of such tax as is properly allocable to that part of such year which begins on the date of the sale shall be treated as a tax imposed on the purchaser.

(2) SPECIAL RULES.—

(A) in the case of any sale of real property, if—

(i) a taxpayer may not, by reason of his method of accounting, deduct any amount for taxes unless paid, and

(ii) the other party to the sale is (under the law imposing the real property tax) liable for the real property tax for the real property tax year,

then for purposes of subsection (a) the taxpayer shall be treated as having paid, on the date of the sale, so much of such tax as, under paragraph (1) of this subsection, is treated as imposed on the tax-



payer. For purposes of the preceding sentence, if neither party is liable for the tax, then the party holding the property at the time the tax becomes a lien on the property shall be considered liable for the real property tax for the real property tax year.

(B) paragraph (1) shall apply to taxable years ending after December 31, 1953, but only in the case of sales after December 31, 1953.

(C) paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for a taxable year which ended before January 1, 1954.

(D) in the case of any sale of real property, if the taxpayer's taxable income for the taxable year during which the sale occurs is computed under an accrual method of accounting, and if no election under section 461 (c) (relating to the accrual of real property taxes) applies, then, for purposes of subsection (a), that portion of such tax which—

(i) is treated, under paragraph (1) of this subsection, as imposed on the taxpayer, and

(ii) may not, by reason of the taxpayer's method of accounting, be deducted by the taxpayer for any taxable year,

shall be treated as having accrued on the date of the sale.

(e) TAXES OF SHAREHOLDER PAID BY CORPORATION.—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

(f) CROSS REFERENCE.—For provisions disallowing any deduction for the payment of the tax imposed by subchapter B of chapter 3 (relating to tax-free covenant bonds) see section 1451 (f).

§ 1.164-1 DEDUCTION FOR TAXES.—Except as otherwise provided in this section and in §§ 1.164-2 to 1.164-7, inclusive, taxes imposed by the United States, any State, Territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. See section 461 for the general rule for taxable year of deduction. Amounts paid to States or Territories under secured-debts laws in order to render securities tax-exempt are deductible. Automobile license fees are ordinarily taxes. Postage is not a tax. In general, taxes are deductible only by the person upon whom they are imposed. See section 164(d) and § 1.164-6 for apportionment of taxes on real property between seller and purchaser. For provisions disallowing any deduction for the tax paid at the source on interest from tax-free covenant bonds, see section 1451(f).

§ 1.164-2 DEDUCTION DENIED IN CASE OF CERTAIN TAXES.—This section and §§ 1.164-3 and 1.164-4 describe certain taxes for which no deduction is allowed or with respect to which the allowance of the deduction is subject to certain conditions. No deduction is allowed for:

(a) Federal income taxes, including the taxes imposed by section 3101, relating to the tax on employees under the Federal Insurance Contributions Act; sections 3201 and 3211, relating to the taxes on railroad employees and railroad employee representatives; section 3402, relating to the tax withheld at source on wages; and by corresponding provisions of prior internal revenue laws.

(b) Federal war profits and excess profits taxes including those

imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, section 702 of the Revenue Act of 1934, subchapter D of chapter 1 of the Internal Revenue Code of 1939, and subchapter E of chapter 2 of the Internal Revenue Code of 1939.

(c) Estate, inheritance, legacy, succession, and gift taxes.

(d) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and of possessions of the United States.

(e) Taxes on real property, to the extent that section 164(d) and § 1.164-6 require such taxes to be treated as imposed on another taxpayer.

§ 1.164-3 **FEDERAL DUTIES AND EXCISE TAXES.**—No deduction is allowed under section 164 for Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in paragraphs (a), (b), or (c) of § 1.164-2, or § 1.164-4), paid or accrued within the taxable year. The fact that any such tax is not deductible as a tax under section 164 does not prevent (a) its deduction under section 162 or section 212, provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in the conduct of any trade or business or, in the case of an individual, for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, or (b) its being taken into account during the taxable year by a corporation or an individual as a part of the cost of acquiring or producing property in the trade or business or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which it relates.

§ 1.164-4 **TAXES FOR LOCAL BENEFITS.**—(a) Except as provided in paragraph (b) of this section, so-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. For treatment

of assessments for local benefits as adjustments to the basis of property see section 1016(a) (1) and the regulations thereunder.

(b) (1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

(2) Taxes levied by a special taxing district are deductible if the district covers the whole of at least one county, if at least 1,000 persons are subject to the taxes levied by the district, and if the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

#### § 1.164-5 CERTAIN RETAIL SALES TAXES AND GASOLINE TAXES.—

(a) Any amount representing a State or local sales tax paid by a consumer of services or tangible personal property is deductible by such consumer as a tax, provided it is separately stated and not paid in connection with his trade or business. The fact that, under the law imposing it, the incidence of the State or local sales tax does not fall on the consumer is immaterial. The requirement of section 164(c) (1) that the amount of the tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. Where the law imposing the State or local sales tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the State or local sales tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a gasoline tax imposed upon a wholesaler unless such provisions of law apply with respect to both the sale at wholesale and the sale at retail.

(b) As used in this section the term "State or local sales tax" means a tax imposed by a State, a Territory, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia upon persons engaged in selling tangible personal property at retail, or on persons selling gasoline or other motor vehicle fuels at wholesale or retail, which is a stated sum per unit of such property sold or which is measured by the gross sales price or the gross receipts from the sale. The term also includes a tax imposed by such authorities upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services.

(c) In general, the term "consumer" means the ultimate user or purchaser; it does not include a purchaser, such as a retailer, who acquires the property for resale.

#### § 1.164-4(b) (1)

§ 1.164-6 APPORTIONMENT OF TAXES ON REAL PROPERTY BETWEEN SELLER AND PURCHASER.—(a) *Scope*.—When real property is sold, section 164(d)(1) governs the deduction by the seller and the purchaser of current real property taxes. Section 164(d)(1) performs two functions: (1) It provides a method by which a portion of the taxes for the real property tax year in which the property is sold may be deducted by the seller and a portion by the purchaser; and (2) it limits the deduction of the seller and the purchaser to the portion of the taxes corresponding to the part of the real property tax year during which each was the owner of the property. These functions are accomplished by treating a portion of the taxes for the real property tax year in which the property is sold as imposed on the seller and a portion as imposed on the purchaser. To the extent that the taxes are treated as imposed on the seller and the purchaser, each shall be allowed a deduction, under section 164(a), in the taxable year such tax is paid or accrued, or treated as paid or accrued under section 164(d)(2)(A) or (D) and this section. No deduction is allowed for taxes on real property to the extent that they are imposed on another taxpayer, or are treated as imposed on another taxpayer under section 164(d). For the election to accrue real property taxes ratably see section 461(c) and the regulations thereunder.

(b) *Application of rule of apportionment*.—(1)(i) For purposes of the deduction provided by section 164(a), if real property is sold during any real property tax year, the portion of the real property tax properly allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and the portion of such tax properly allocable to that part of such real property tax year which begins on the date of the sale shall be treated as a tax imposed on the purchaser. For definition of “real property tax year” see paragraph (c) of this section. This rule shall apply whether or not the seller and the purchaser apportion such tax. The rule of apportionment contained in section 164(d)(1) applies even though the same real property is sold more than once during the real property tax year. (See paragraph (d)(5) of this section for rule requiring inclusion in gross income of excess deductions.)

(ii) Where the real property tax becomes a personal liability or a lien before the beginning of the real property tax year to which it relates and the real property is sold subsequent to the time the tax becomes a personal liability or a lien but prior to the beginning of the related real property tax year—

(a) The seller may not deduct any amount for real property taxes for the related real property tax year, and

(b) To the extent that he holds the property for such real property tax year, the purchaser may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the seller, mortgagee, trustee or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iii) Similarly, where the real property tax becomes a personal liability or a lien after the end of the real property tax year to which it relates and the real property is sold prior to the time the tax be-

comes a personal liability or a lien but after the end of the related real property tax year—

(a) The purchaser may not deduct any amount for real property taxes for the related real property tax year, and

(b) To the extent that he holds the property for such real property tax year, the seller may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iv) Where the real property is sold (or purchased) during the related real property tax year the real property taxes for such year are apportioned between the parties to such sale and may be deducted by such parties in accordance with the provisions of paragraph (d) of this section.

(2) Section 164(d) does not apply to delinquent real property taxes for any real property tax year prior to the real property tax year in which the property is sold.

(3) The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* The real property tax year in County R is April 1 to March 31. A, the owner on April 1, 1954, of real property located in County R sells the real property to B on June 30, 1954. B owns the real property from June 30, 1954, through March 31, 1955. The real property tax for the real property tax year April 1, 1954–March 31, 1955 is \$365. For purposes of section 164(a), \$90 ( $90/365 \times \$365$ , April 1, 1954–June 29, 1954) of the real property tax is treated as imposed on A, the seller, and \$275 ( $275/365 \times \$365$ , June 30, 1954–March 31, 1955) of such real property tax is treated as imposed on B, the purchaser.

*Example (2).* In County S the real property tax year is the calendar year. The real property tax becomes a lien on June 1 and is payable on July 1 of the current real property tax year, but there is no personal liability for such tax. On April 30, 1955, C, the owner of real property in County S on January 1, 1955, sells the real property to D. On July 1, 1955, D pays the 1955 real property tax. On August 31, 1955, D sells the same real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 119/365 (January 1–April 29, 1955) of the real property tax payable on July 1, 1955, for the 1955 real property tax year is treated as imposed on C, and, under the provisions of section 164(d)(2)(A), such portion is treated as having been paid by him on the date of sale. Under the provisions of section 164(d)(1), 123/365 (April 30–August 30, 1955) of the real property tax paid July 1, 1955, for the 1955 real property tax year is treated as imposed on D and may be deducted by him. Under the provisions of section 164(d)(1), 123/365 (August 31–December 31, 1955) of the real property tax due and paid on July 1, 1955, for the 1955 real property tax year is treated as imposed on E and, under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale.

*Example (3).* In State X the real property tax year is the calendar year. The real property tax becomes a lien on November 1 of the preceding calendar year. On November 15, 1955, F sells real property in State X to G. G owns the real property through December 31, 1956. Under section 164(d)(1), the real property tax (which became a lien on November 1, 1954) for the 1955 real property tax year is apportioned between F and G. No part of the real property tax for the 1956 real property tax year may be deducted by F. The entire real property tax for the 1956 real property tax year may be deducted by G when paid or accrued, depending upon the method of accounting used by him. See subparagraph (6) of paragraph (d) and section 461(c) and the regulations thereunder.

(c) *Real property tax year.*—As used in section 164(d), the term “real property tax year” refers to the period which, under the law imposing the tax, is regarded as the period to which the tax imposed relates. Where the State and one or more local Governmental units each imposes a tax on real property, the real property tax year for each tax must be determined for purposes of applying the rule of apportionment of section 164(d)(1) to each tax. The time when the tax rate is determined, the time when the assessment is made, the time when the tax becomes a lien, or the time when the tax becomes due or delinquent does not necessarily determine the real property tax year. The real property tax year may or may not correspond to the fiscal year of the governmental unit imposing the tax. In each case the State or local law determines what constitutes the real property tax year. Although the seller and the purchaser may or may not make an allocation of real property taxes, the meaning of “real property tax year” in section 164(d) and the application of section 164(d) do not depend upon what real property taxes were allocated or the method of allocation used by the parties.

(d) *Special rules.*—(1) *Seller using cash receipts and disbursements method of accounting.*—Under the provisions of section 164(d), if the seller by reason of his method of accounting may not deduct any amount for taxes unless paid, and—

(i) The purchaser (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, or

(ii) The seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year and the tax is not payable until after the date of sale,

then the portion of the tax treated under section 164(d)(1) as imposed upon the seller (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security.

(2) *Purchasers using the cash receipts and disbursements method of accounting.*—Under the provisions of section 164(d), if the pur-

chaser by reason of his method of accounting may not deduct any amount for taxes unless paid and the seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, the portion of the tax treated under section 164(d) (1) as imposed upon the purchaser (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the seller, mortgagee, trustee, or other person having an interest in the property as security.

(3) *Persons considered liable for tax.*—Where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. As to a particular sale, in determining:

(i) Whether the other party to the sale is liable for the tax or,

(ii) The person who holds the property at the time the tax becomes a lien on the property (where the tax is not a liability of any person),  
prior or subsequent sales of the property during the real property tax year shall be disregarded.

(4) *Examples.*—The provisions of subparagraphs (1), (2), and (3) of this paragraph may be illustrated as follows:

*Example (1).* In County X the real property tax year is the calendar year. The real property tax is a personal liability of the owner of the real property on June 30 of the current real property tax year, but is not payable until February 28 of the following real property tax year. A, the owner of real property in County X on January 1, 1955, uses the cash receipts and disbursements method of accounting. On May 30, 1955, A sells the real property to B, who also uses the cash receipts and disbursements method of accounting. B retains ownership of the real property for the balance of the 1955 calendar year. Under the provisions of section 164(d) (1), 149/365 (January 1–May 29, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on A, the seller, and under the provisions of section 164(d) (2) (A) such portion is treated as having been paid by him on the date of sale and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d) (1), 216/365 (May 30–December 31, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on B, the purchaser, and may be deducted by him for his taxable year in which the tax is actually paid, or an amount representing such tax is paid.

*Example (2).* In County Y, the real property tax year is the calendar year. The real property tax becomes a lien on January 1, 1955, and is payable on April 30, 1955. There is no personal liability for the real property tax imposed by County Y. On April 30, 1955, C

the owner of real property in County Y on January 1, 1955, pays the real property tax for the 1955 real property tax year. On May 1, 1955, C sells the real property to D. On September 1, 1955, D sells the real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d) (1), 120/365 (January 1–April 30, 1955) of the real property tax is treated as imposed upon C and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid. Under section 164(d) (1), 123/365 (May 1–August 31, 1955) of the real property tax is treated as imposed upon D, and under the provisions of section 164(d) (2) (A) is treated as having been paid by him on May 1, 1955, and may be deducted by D for his taxable year in which the sale from C to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid. Since, according to paragraph (d) (3) of this section, the prior sale by C to D is disregarded, under the provisions of section 164(d) (1), 122/365 (September 1–December 31, 1955) of the real property tax is treated as imposed on E, and under the provisions of section 164(d) (2) (A) is treated as having been paid by him on September 1, 1955, and may be deducted by E for his taxable year in which the sale from D to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid.

*Example (3).* In County X the real property tax year is the calendar year and the real property taxes are assessed and become a lien on June 30 of the current real property tax year, but are not payable until September 1 of that year. There is no personal liability for the real property tax imposed by County X. A, the owner on January 1, 1955, of real property in County X, uses the cash receipts and disbursements method of accounting. On July 15, 1955, A sells the real property to B. Under the provisions of section 164(d) (1), 195/365 (January 1–July 14, 1955) of the real property tax payable on September 1, 1955, for the 1955 real property tax year is treated as imposed on A, and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d) (1), 170/365 (July 15–December 31, 1955) of the real property tax is treated as imposed on B and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which the tax is actually paid or an amount representing such tax is paid.

(5) *Treatment of excess deduction.*—If, for a taxable year prior to the taxable year of sale of real property, a taxpayer has deducted an amount for real property tax in excess of the portion of such real property tax treated as imposed on him under the provisions of section 164(d), the excess of the amount deducted over the portion treated as imposed on him shall be included in his gross income for the taxable year of the sale, subject to the provisions of section 111, relating to the



recovery of bad debts, prior taxes, and delinquency amounts. The provisions of this subparagraph may be illustrated as follows:

*Example (1).* In Borough Y the real property tax is due and payable on November 30 for the succeeding calendar year, which is also the real property tax year. On November 30, 1954, taxpayer A, who reports his income on a calendar year under the cash receipts and disbursements method of accounting, pays the real property tax on real property owned by him in Borough Y for the 1955 real property tax year. On June 30, 1955, A sells the real property. Under the provisions of section 164(d), only 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and the excess of the amount of real property tax for 1955 deducted by A, on his 1954 income tax return, over the 180/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in A's 1955 income tax return, subject to the provisions of section 111.

*Example (2).* In County Z the real property tax year is the calendar year. The real property tax becomes a personal liability of the owner of real property on January 1 of the current real property tax year, and is payable on July 1 of the current real property tax year. On May 1, 1955, A, the owner of real property in County Z on January 1, 1955, sells the real property to B. On November 1, 1955, B sells the same real property to C. B uses the cash receipts and disbursements method of accounting and reports his income on the basis of a fiscal year ending July 31. B, on July 1, 1955, pays the entire real property tax for the real property tax year ending December 31, 1955. Under the provisions of section 164(d), only 184/365 (May 1–October 31, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on B, and the excess of the amount of real property tax for 1955 deducted by B on his income tax return for the fiscal year ending July 31, 1955, over the 184/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in B's income tax return for his fiscal year ending July 31, 1956, subject to the provisions of section 111.

(6) *Persons using an accrual method of accounting.*—Where real property is sold and the seller or the purchaser computes his taxable income (for the taxable year during which the sale occurs) on an accrual method of accounting, then, if the seller or the purchaser has not made the election provided in section 461(c) (relating to the accrual of real property taxes), the portion of any real property tax which is treated as imposed on him and which may not be deducted by him for any taxable year by reason of his method of accounting shall be treated as having accrued on the date of sale. The provisions of this subparagraph may be illustrated as follows:

*Example.* In County X the real property tax becomes a lien on property and is assessed on November 30 for the current calendar year, which is also the real property tax year. There is no personal liability for the real property tax imposed by County X. A owns, on January 1, 1955, real property in County X. A uses an accrual method of accounting and has not made any election under section 461(c) to accrue ratably real property taxes. A sells real property

on June 30, 1955. By reason of A's method of accounting, he could not deduct any part of the real property tax for 1955 on the real property since he sold the real property prior to November 30, 1955, the accrual date. Under section 164(d)(1), 180/365 (January 1-June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and under section 164(d)(2)(D) that portion is treated as having accrued on June 30, 1955, and may be deducted by A for his taxable year in which such date falls. B, the purchaser from A, who uses an accrual method of accounting, has likewise not made an election under section 461(c) to accrue real property taxes ratably. Under section 164(d)(1), 185/365 of the real property taxes may be accrued by B on November 30, 1955, and deducted for his taxable year in which such date falls.

(7) *Cross references.*—For determination of amount realized on a sale of real property, see section 1001(b) and the regulations thereunder. For determination of basis of real property acquired by purchase, see section 1012 and the regulations thereunder.

(8) *Effective dates.*—Section 164(d) applies to taxable years ending after December 31, 1953, but only in the case of sales made after December 31, 1953. However, section 164(d) does not apply to any real property tax to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for any taxable year which ended before January 1, 1954.

§ 1.164-7 TAXES OF SHAREHOLDERS PAID BY CORPORATION.—Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

## § 1.171 STATUTORY PROVISIONS; ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS; AMORTIZABLE BOND PREMIUM.

### SEC. 171. AMORTIZABLE BOND PREMIUM.

(a) *GENERAL RULE.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) *INTEREST WHOLLY OR PARTIALLY TAXABLE.*—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *INTEREST WHOLLY TAX-EXEMPT.*—In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *ADJUSTMENT OF CREDIT OR DEDUCTION FOR INTEREST PARTIALLY TAX-EXEMPT.*—

(A) *INDIVIDUALS.*—In the case of any bond the interest on which is allowable as a credit under section 35, the amount which would otherwise be taken into account in computing such credit shall be reduced by the amount of the amortizable bond premium for the taxable year.

(B) *CORPORATIONS.*—In the case of any bond the interest on which is allowable as a deduction under section 242, such deduction shall be reduced by the amount of the amortizable bond premium for the taxable year.

(4) CROSS REFERENCE.—For adjustment to basis on account of amortizable bond premium, see section 1016(a)(5).

(b) AMORTIZABLE BOND PREMIUM.—(1) AMOUNT OF BOND PREMIUM.—For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

(A) with reference to the amount of the basis (for determining loss on sale or exchange) of such bond,

(B) with reference to the amount payable on maturity or on earlier call date (but in the case of bonds described in subsection (c)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than 3 years after the date of such issue), and

(C) with adjustments proper to reflect unamortized bonds premium, with respect to the bond, for the period before the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) AMOUNT AMORTIZABLE.—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. In the case of a bond described in subsection (c)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of bond premium attributable to the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity.

(3) METHOD OF DETERMINATION.—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium prescribed by the Secretary or his delegate.

(c) ELECTION AS TO TAXABLE AND PARTIALLY TAXABLE BONDS.—

(1) ELIGIBILITY TO ELECT; BONDS WITH RESPECT TO WHICH ELECTION PERMITTED.—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply:

(A) PARTIALLY TAX-EXEMPT.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 35 is allowable; and

(B) WHOLLY TAXABLE.—In the case of any taxpayer, bonds the interest on which is not excludable from gross income but with respect to which the credit provided in section 35, or the deduction provided in section 242, is not allowable.

(2) MANNER AND EFFECT OF ELECTION.—The election authorized under this subsection shall be made in accordance with such regulations as the Secretary or his delegate shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to revoke such election. In the case of bonds held by common trust fund, as defined in section 584(a), or by a foreign personal holding company, as defined in section 552, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company. In case of bonds held

by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

(d) **BOND DEFINED.**—For purposes of this section, the term “bond” means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(e) **DEALERS IN TAX-EXEMPT SECURITIES.**—For special rules applicable, in the case of dealers in securities, with respect to premium attributable to certain wholly tax-exempt securities, see section 75.

§ 1.171-1 **AMORTIZABLE BOND PREMIUM.**—(a) *In general.*—Under section 171, bond premium is amortizable by the owner of the bond (as defined in § 1.171-4) in accordance with subparagraph (1) or (2) of this paragraph as follows:

(1) Amortization of bond premium is mandatory with respect to—

(i) Fully tax-exempt bonds (the interest on which is excludable from gross income), whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds owned by a corporation.

(2) Amortization of bond premium is optional, at the election of the taxpayer, with respect to—

(i) Fully taxable bonds, whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds owned by taxpayers other than corporations.

(b) *Operation.*—(1) In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bond. Thus, if such premium is \$1, the basis or adjusted basis of the bond is reduced by \$1. No deduction is allowable on account of such amortizable bond premium. See paragraph (b) (2) of § 1.171-2 for treatment of bonds with alternative call dates.

(2) In the case of a fully taxable bond to which section 171 is applicable, the amortizable bond premium is applied both as an adjustment to the basis or adjusted basis of the bond and as a deduction in computing taxable income. For the disallowance of a deduction in certain cases, see paragraph (a) (3) of § 1.171-2.

(3) In the case of a partially tax-exempt bond, the amortizable bond premium for the taxable year is used for the following purposes:

(i) As an adjustment to the basis or adjusted basis of the bond;

(ii) As a deduction in computing taxable income;

(iii) In the case of individuals, estates, or trusts, as a reduction of the amount which would otherwise be taken into account in computing the credit against the tax provided under section 35; or

(iv) In the case of corporations, as a reduction of the amount allowed under section 242 as a deduction in computing taxable income.

(4) The application of the provisions of subparagraph (3) of this paragraph relating to a partially tax-exempt bond may be illustrated by the following example:

*Example.* In the case of an individual who has elected to amortize the premium on a partially tax-exempt bond, if the interest on such bond with an adjusted basis of \$1,024 is \$30 for the taxable year, and the amortizable bond premium thereon is \$4 for the taxable year, then the \$30 is included in gross income, the \$4 is allowable as a deduction, the adjusted basis of \$1,024 is reduced by \$4 to \$1,020, and a credit amounting to \$.78 (3% of \$30 minus \$4) is allowed against the tax for such taxable year. In the case of a corporation, which is required to amortize the premium on such bond, no credit is allowed against the tax, but the deduction under section 242 on account of the interest is \$26 (\$30 minus \$4).

(5) In the case where no specific deduction is permitted under section 171 (a) for amortization of bond premium as such, because the tax is computed for the taxpayer under section 3 by use of the optional tax tables, or because the taxpayer elects under section 144 to take the standard deduction, it shall be deemed, if the taxpayer has elected to amortize bond premium in accordance with the provisions of section 171, that the deduction for amortization of bond premium has been allowed for the purpose of determining the adjusted basis of the bond.

(c) *Bonds owned by decedents.*—(1) *Decedents using cash receipts and disbursements method of accounting.*—(i) Where a decedent who used the cash receipts and disbursements method of accounting owned fully taxable bonds to which section 171 applies—

(a) The interest accruing thereon during the period ending with his death is, by reason of section 691, included upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, and

(b) The amount of amortizable bond premium properly allowable for such period is a deduction for such period to the decedent and is not allowable as a deduction to the estate or legatee.

(ii) Where a decedent who used the cash receipts and disbursements method of accounting owned partially tax-exempt bonds to which section 171 applies—

(a) The interest accruing thereon during the period ending with his death is, by reason of section 691, included upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, and

(b) The amount of the amortizable bond premium properly allowable for such period is a deduction for such period to the decedent, as in the case of a fully taxable bond, and

(c) The amount of the amortizable bond premium shall not be applied to reduce the estate's or legatee's credit or deduction for such interest for such period.

(2) *Illustration.*—The provisions of subparagraph (1) (ii) of this paragraph relating to a partially tax-exempt bond may be illustrated by the following example:

*Example.* At the time of his death in 1956, D owned a partially tax-exempt bond to which section 171 applies. For the period beginning January 1, 1956, and ending with D's death on September 30, 1956, the accrued interest on such bond is \$25 and the amortizable bond premium is \$2. D's estate has the right to receive such interest. D's executor, in making the income tax return for D's last taxable

year (January 1 to September 30, 1956), may take into account a deduction of \$2 on account of the amortizable bond premium for such year. D's estate includes the \$25 interest in its gross income upon receipt and, for purposes of the income tax, receives a credit under section 35 of \$.75 (3% of \$25). In computing such credit, the \$25 interest is not reduced on account of the amortizable bond premium which was a deduction allowable for the last taxable year of the decedent.

(3) *Decedents using an accrual method of accounting.*—Where a decedent using an accrual method of accounting owned fully taxable bonds and partially tax-exempt bonds to which section 171 applies—

(i) In the case of fully taxable bonds, both the interest accruing thereon during the period ending with his death and the deduction on account of the amortizable bond premium for such period are taken into account in computing the taxable income of the decedent; and

(ii) In the case of partially tax-exempt bonds, the rule as to the accrued interest and the amortization deduction is the same as in subdivision (i) of this subparagraph, and the amount which would otherwise be taken into account in computing the decedent's credit against tax for such interest is required to be reduced by the amount of the amortizable bond premium for the period ending with the decedent's death.

§ 1.171-2 DETERMINATION OF BOND PREMIUM.—(a) *In general.*—

(1) Except as otherwise provided in this section, bond premium on any bond to which section 171 applies is the excess of the amount of the basis (for determining loss on sale or exchange under section 1011) of the bond over the amount payable at maturity or, in the case of a callable bond, the earlier call date. For determination of applicable call date, see paragraph (b) of this section.

(2) (i) In the case of wholly taxable bonds described in section 171(c)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, the earlier call date may be used in computing the bond premium only if such earlier call date is a date more than 3 years after the date of original issue. The preceding sentence does not apply to: (a) Bonds issued after January 22, 1951, and acquired before January 23, 1954 (for this purpose the date of acquisition shall be considered the date such bonds were ordered under a firm commitment to buy and not the date the bonds were delivered to the taxpayer); or (b) bonds issued before January 23, 1951, and acquired at any time. For determining whether an earlier call date is a date more than 3 years after the date of original issue, consideration will be given to the terms under which the bond is issued. Where a bond described in the first sentence of this subdivision is subject to a call date which falls within 3 years of the date of original issue, the amount of amortizable bond premium may be computed only with respect to the amount payable at maturity, regardless of when such bond was acquired by the taxpayer.

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* Assume that the taxpayer acquired at the date of issue a \$100 bond for \$112, callable at any time thereafter upon 30 days'

notice. The bond was issued on January 1, 1956. The premium of \$12 attributable to such bond may be amortized only with reference to the maturity date of the bond. Similarly, assume that in 1957 the taxpayer acquired a \$100, 20-year bond for \$115. The bond was issued on January 1, 1954, and was callable 2 years after the date of issuance or, if not then called, 10 years after the date of issuance. The premium of \$15 attributable to such bond may be amortized only with reference to the maturity date of the bond.

(iii) In the case of a wholly taxable bond described in section 171(c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of the bond premium attributable to the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity. For adjustments proper to reflect unamortized bond premium for the period before the date as of which section 171 becomes applicable to the bond in the hands of the taxpayer, see subparagraph (4) of this paragraph. For example, if a fully taxable bond, issued on January 1, 1954, and acquired by the taxpayer on January 1, 1955, at a price of \$109, matures in 10 years from the date of issue (9 years from the date of acquisition) but is callable at \$105 on 30 days' notice, section 171(b) (1) (B) requires that the bond be amortized to maturity, that is, at the rate of \$1 per year. If the bond is called on December 31, 1956, for \$105, then \$3, the excess of the adjusted basis of \$108 (\$109 less \$1 deducted in 1955) over the amount received on redemption, \$105, may be deducted for the year 1956.

(3) Whether the purchase and immediate transfer of callable bonds occurs in such a manner as to make the entire transaction not bona fide, and hence the deductions for amortization for bond premium not allowable, will depend on all the facts and circumstances.

(4) If the date as of which the basis of the bond was established precedes the first taxable year with respect to which section 171 applies to the bond, proper adjustments shall be made to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 1223) before the date as of which section 171 first becomes applicable to the bond in the hands of the taxpayer. Such adjustment is required whether an election was made under section 125 of the Internal Revenue Code of 1939 or under section 171 and applies to all bonds to which section 171 is applicable.

(5) The rule relating to adjustments set forth in subparagraph (4) of this paragraph may be illustrated by the following examples:

*Example (1).* On January 1, 1956, T, who makes his income tax returns on the calendar year basis, owns a fully taxable \$100 bond, maturing on January 1, 1966. T purchased this bond on January 1, 1946, for \$120. T elects to have section 171 apply to such bond for 1957 and subsequent taxable years. In determining the amount of bond premium to be amortized over the remaining 9 years of the life of the bond, T is required, but solely for such purpose, to treat the

bond as if he had amortized the bond premium thereon during the prior 11 years, and to make the proper adjustment in the original bond premium. Accordingly, T would treat \$11 as having been amortized during the first 11 years and would be required to amortize the remaining \$9 over the following 9 years. When the bond is redeemed on January 1, 1966, for \$100, only the \$9 attributable to the last 9 years will actually have been amortized, and the basis of the bond will have been reduced only by that amount. The \$11 attributable to the first 11 years will have been treated as an adjustment to the original bond premium but will not have been amortized nor will the basis of the bond have been reduced by that amount. Consequently, T will have a capital loss in the year of redemption on account of the \$11 attributable to the period January 1, 1946, to January 1, 1957.

*Example (2).* On January 1, 1956, X's father gave him a fully taxable \$100 bond maturing on January 1, 1966. X's father had purchased the bond on January 1, 1946, for \$120. The fair market value of the bond at the time of the gift was \$127. X makes his income tax returns on the calendar year basis and elects to amortize the bond premium on the bond during the period 1956-1966. Under section 1015, the cost of the bond to X's father constitutes the basis of the bond in X's hands for determining loss, since such cost is lower than the fair market value of the bond at the time of the gift, and, under section 1223, X's holding period is deemed to include the 10 years during which his father held the bond. X is required to treat the bond as if the bond premium thereon had been amortized during his father's holding period. Thus, X is required to amortize \$10 over the period January 1, 1956, to January 1, 1966, and in the year of redemption will have a capital loss on account of the \$10 attributable to his father's holding period.

*Example (3).* Y, who makes his income tax returns on the calendar year basis, owns a fully tax-exempt \$100 bond maturing on January 1, 1961. He purchased this bond on January 1, 1941, for \$120. On December 31, 1954, Y sells the bond for \$108 and realizes a gain of \$1, computed as follows:

(i) Total bond premium (\$120—\$100) .....	\$20
(ii) Amount of bond premium amortizable if held to maturity (total bond premium minus unamortized bond premium attributable to 1941 (a year to which section 125 of the Internal Revenue Code of 1939 was not applicable), \$20—\$1) .....	19
(iii) Amount of bond premium amortized from January 1, 1942, through December 31, 1954, (\$1 for each such year) .....	13
(iv) Adjusted basis of bond at close of 1954 (\$120—\$13) .....	107
(v) Gain (\$108—\$107) .....	1

(6) Amortizable bond premium on any bond to which section 171 applies is that part of the bond premium on the bond which is attributable to the taxable year.

(b) *Callable bonds.*—(1) For purposes of section 171, in the case of a callable bond, the earlier call date will be considered as the maturity date, except as provided in paragraphs (a) (2) and (3) of this section. The amount due on the earlier call date will be considered as the amount payable on maturity unless it is determined under a differ-



end method of amortization regularly employed by the taxpayer that another amount shall be the amount payable on maturity. Hence, in the case where a bond premium is to be amortized to the earlier call date, the bond premium on such bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than to the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer.

(2) Where a deduction for amortizable bond premium may be determined with respect to alternative call dates, the amount of amortizable bond premium calculated with reference to a particular call date must be calculated thereafter with reference to the same call date. However, if, upon such call date originally selected, the bond has not in fact been called, the bond premium then unamortized must be amortized to a succeeding call date or to maturity. Thus, assume a \$100 bond is acquired at time of issue for \$125. The bond is callable in five years at \$115 and in 10 years at \$110. The taxpayer may amortize \$10 of premium during the first five years and, if the bond is not then called, an additional \$5 of premium during the next five years. If the bond is not called at the end of ten years, the remaining \$10 of premium must be amortized to maturity.

(c) *Convertible bonds*.—(1) The fact that a bond is convertible into stock does not, in itself, prevent the application of section 171. A convertible bond is within the scope of such section if the option to convert on a date certain specified in the bond rests with the holder thereof. However, for the purpose of determining the amount of amortizable bond premium on a convertible bond for the taxable year, the amount of bond premium shall not include any amount attributable to the conversion features of the bond. For the purpose of the rule stated in the preceding sentence, the term “convertible bond” includes a bond issued with detachable stock-purchase warrants.

(2) The value of the conversion features of a particular bond shall be ascertained as of the time of acquisition by reference to the assumed price at which such bond would be purchased on the open market if without conversion features, and by subtracting such assumed price from the cost of the bond. The assumed price of the bond without conversion features shall be ascertained by comparison to the yields on which bonds of similar character, not having conversion features, are sold on the open market and adjusting the price of the bond in question to this yield. This adjustment may be made by the use of standard bond tables. In selecting quotations for comparative purposes, bonds of the same classification and grade shall be used.

(3) The application of the principles set forth in this paragraph may be illustrated as follows:

*Example.* T purchased for \$115 a \$100 bond, maturing in 10 years, on which interest is payable semiannually at the rate of 3 percent a year. This bond is convertible into common stock at the option of the holder. It is found that bonds of the same character, not

having conversion features, were sold on the open market on or about the time of T's purchase on a basis to yield 2.6 percent. By recourse to a standard bond table, it is found that the cost of a 3-percent, 10-year, \$100 bond to yield 2.6 percent would have been \$103.50. Since the taxpayer paid \$115 for the convertible bond, the difference between \$115 and \$103.50, or \$11.50, represents the value of the conversion features of the bond at the time of purchase. The balance of \$3.50 represents the bond premium subject to amortization under section 171.

(4) If a convertible bond acquired on or before June 15, 1950, is held during the taxable year, the amortizable bond premium shall be computed as if the provisions for the determination of the bond premium without the inclusion of any amount attributable to the conversion features of the bond were applicable for each year for which the bond was held prior to such taxable year. Thus, if T, in the example in subparagraph (3) of this paragraph, had acquired the bond on January 1, 1949, and if T makes his income tax returns on the basis of the calendar year, the amortizable bond premium for 1957 would be \$0.35, determined as follows:

Bond premium not attributable to conversion feature.....	\$3.50
Amortizable bond premium for 1949 and 1950, determined by reference to bond premium not attributable to conversion feature.....	.70

Portion of bond premium amortizable over remaining life of bond.....	\$2.80
Amortizable bond premium for each of the remaining 8 years, including the taxable year 1957 (one-eighth of \$2.80).....	.35

(d) *Capitalized expenses.*—(1) In the case of a bond to which section 171 otherwise applies, on which the bond premium is attributable only to capitalized expenses (such as buying commissions), if a taxpayer—

(i) Regularly employs a reasonable method of amortization under which capitalized expenses are amortized, or

(ii) Is required by the regulations to use the method of amortization prescribed by paragraph (f) of this section, or

(iii) Regularly employs a reasonable method of amortization but does not amortize capitalized expenses,  
such taxpayer is permitted, but is not required, to amortize capitalized expenses in accordance with such method.

(2) In the case of a bond to which section 171 applies and on which there is bond premium exclusive of capitalized expenses—

(i) If a taxpayer regularly employs a reasonable method of amortization under which capitalized expenses are treated as being part of the bond premium for purposes of amortization, such capitalized expenses must be treated as being a part of the bond premium for the purposes of section 171.

(ii) If a taxpayer is required by regulations to use the method of amortization prescribed by paragraph (f) of this section, he must treat capitalized expenses as being part of the bond premium for purposes of section 171.

(iii) If a taxpayer regularly employs a method of amortization under which capitalized expenses are not treated as being part of the bond premium for the purposes of amortization, he is permitted, but

is not required, to treat such capitalized expenses as being part of the bond premium for the purposes of section 171.

(e) *Taxable years in which interest not received or accruable*.—In the case of a taxpayer who makes his income tax returns on the cash receipts and disbursements method or one who makes his returns on an accrual method and who owns a bond to which section 171 applies and in respect of which no interest is received or accrued by the taxpayer during the taxable year, if the taxpayer—

(1) Regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is amortized, or

(2) Is required by the regulations to use the method of amortization prescribed by paragraph (f) of this section, or

(3) Regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is not amortized,

such taxpayer is permitted, but not required, to amortize bond premium on the bond for such taxable year in accordance with such method.

(f) *Methods of amortization*.—(1) Determination of the bond premium and amortizable bond premium on any bond to which section 171 applies shall be made in accordance with:

(i) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(ii) In all other cases, the method of amortization prescribed by this section.

A method of amortization, for example, the composite method described in § 1.1016-9, will be deemed “regularly employed” by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1954, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(2) The bond premium to be amortized shall be determined under the following method:

(i) The amortizable bond premium on such bond attributable to the taxable year under paragraph (a) (6) of this section shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was held by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or

earlier call date. For the purposes of this subdivision, a fractional part of a month shall be disregarded unless it amounts to more than half of a month, in which case it shall be considered as a month.

(ii) For purposes of subdivision (i) of this subparagraph, the bond premium as of any date on any bond to which section 171 applies shall be determined in accordance with paragraph (a) of this section by ascertaining the excess of the amount of the basis of the bond, as determined under section 1011 (adjusted to date for amortizable bond premium under section 1016), over the amount payable at maturity or, in the case of a callable bond, the earlier call date (except as otherwise provided in subparagraphs (2) and (3) of paragraph (a) of this section).

(3) The application of the provisions of this paragraph relating to method of amortization may be illustrated by the following example:

*Example.* (i) A taxpayer, who makes calendar year returns, on June 20, 1955, acquires at a cost of \$119 a \$100 bond issued January 1, 1955, maturing January 1, 1965. The amortizable bond premium as of the last day of 1955 is computed as follows:

Bond premium at date of acquisition.....	\$19
Number of months in 1955 during which bond is held by the taxpayer..	6
Number of months from date of acquisition to date of maturity.....	114
Amortizable bond premium ( $\frac{6}{114} \times \$19$ ) equals .....	1

(ii) The bond premium as of the close of 1955 would be computed as follows:

Bond premium at date of acquisition (or first day of taxable year)....	\$19
Amortizable bond premium for period during which bond was owned in 1955 .....	1
Bond premium as of the close of the taxable year 1955.....	18

(iii) If the bond in this example were issued with a call date not more than 3 years after issue date, the premium would also be amortized to maturity as indicated above, because of the application of paragraph (a) (2) of this section.

(4) For the method of amortization in the case of individual mortgages purchased, acquired, or originated at a premium by mutual savings banks, building and loan associations, and cooperative banks, see section 1016 and § 1.1016-9.

§ 1.171-3 ELECTION WITH RESPECT TO TAXABLE AND PARTIALLY TAXABLE BONDS.—(a) *In general.*—In the case of a corporation, the election provided in section 171 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to the following classes: (1) Fully taxable bonds only, or (2) partially tax-exempt bonds only, or (3) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election will be recognized. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election

shall apply to all the bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all the bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. In the case of bonds owned by a partnership, common trust fund, or foreign personal holding company, the election shall be exercisable by such partnership (as provided in section 703(b), common trust fund, or foreign personal holding company.

(b) *Special rule for transition period.*—For taxable years beginning after December 31, 1953, and ending after August 16, 1954, the election to deduct amortizable bond premium applies to premiums on both of the following types of bonds:

(1) Those with interest coupons or in registered form, and

(2) Those without interest coupons and not in registered form, including those commonly referred to as "corporate mortgages".

If a taxpayer claimed a deduction for amortizable bond premium in a return filed for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, to which the election under section 171 is applicable to the taxpayer, and such deduction did not include amortizable bond premiums for both types of bonds, described in subparagraphs (1) and (2) of this paragraph, held by the taxpayer during such taxable year, such election with respect to the deduction of amortizable bond premiums shall not constitute a valid election unless such election is perfected in accordance with this paragraph in an amended return for such taxable year filed not later than the 90th day after publication in the Federal Register of the regulations under section 171. Such amended return shall have attached thereto a statement showing a recomputation of the deduction, in accordance with the provisions of section 171 and this section, for amortizable bond premium on both such types of bonds. If such election is not perfected as provided in this paragraph, no deduction shall be allowed for amortization of premium on any bond to which the election is applicable, whether or not with interest coupons or in registered form. If a return has been filed for a subsequent taxable year, such return shall be conformed to the election made with respect to such first taxable year by filing an amended return for such subsequent taxable year, if necessary.

(c) *Partially tax-exempt bonds owned by estates, trusts, partnerships, etc.*—If a trust owning partially tax-exempt bonds elects to amortize the bond premium thereon under section 171, the credits of the trust and the credits and deductions of the beneficiaries on account of such interest are required to be reduced by the portion of the amortization deduction attributable to their shares of such interest. See section 642(a)(1). A similar rule is applicable in the case of partially tax-exempt bonds owned by estates, common trust funds, partnerships, and foreign personal holding companies.

§ 1.171-4 DEFINITION.—(a) The term "bond", as used in section 171, means any bond, debenture, note, or certificate or other evidence

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of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), but the term does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This definition of a bond is applicable to bonds, whether or not with coupons or in registered form, held or acquired in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) For taxable years beginning before January 1, 1954, or taxable years beginning after December 31, 1953, but ending on or before August 16, 1954, the term "bond", as defined in paragraph (a) of this section, applies only to a bond, debenture, note, or certificate of other evidence of indebtedness with interest coupons or in registered form.

(c) Section 171 has no application to bonds held by dealers in securities other than bonds held by such dealers for investment pursuant to section 1236 and the regulations thereunder. See, however, § 1.75-1, relating to the treatment of bond premiums in case of dealers in tax-exempt securities.

## § 1.173 STATUTORY PROVISIONS; ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS; CIRCULATION EXPENDITURES.

### SEC. 173. CIRCULATION EXPENDITURES.

Notwithstanding section 263, all expenditures (other than expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical) to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical shall be allowed as a deduction; except that the deduction shall not be allowed with respect to the portion of such expenditures as, under regulations prescribed by the Secretary or his delegate, is chargeable to capital account if the taxpayer elects, in accordance with such regulations, to treat such portion as so chargeable. Such election, if made, must be for the total amount of such portion of the expenditures which is so chargeable to capital account, and shall be binding for all subsequent taxable years unless, upon application by the taxpayer, the Secretary or his delegate permits a revocation of such election subject to such conditions as he deems necessary.

§ 1.173-1 CIRCULATION EXPENDITURES.—(a) *Allowance of deduction.*—Section 173 provides for the deduction from gross income of all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, subject to the following limitations:

(1) No deduction shall be allowed for expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical;

(2) The deduction shall be allowed only to the publisher making the circulation expenditures; and

(3) The deduction shall be allowed only for the taxable year in which such expenditures are paid or incurred.

Subject to the provisions of paragraph (c) of this section, the deduc-

tion permitted under section 173 and this paragraph shall be allowed without regard to the method of accounting used by the taxpayer and notwithstanding the provisions of section 263 and the regulations thereunder, relating to capital expenditures.

(b) *Deferred expenditures*.—Notwithstanding the provisions of paragraph (a) (3) of this section, expenditures paid or incurred in a taxable year subject to the Internal Revenue Code of 1939 which are deferrable pursuant to I. T. 3369 [C. B. 1940-1, 46], as modified by Rev. Rul. 57-87 [I. R. B. 1957-10, 19], may be deducted in the taxable year subject to the Internal Revenue Code of 1954 to which so deferred.

(c) *Election to capitalize*.—(1) A taxpayer entitled to the deduction for circulation expenditures provided in section 173 and paragraph (a) of this section may, in lieu of taking such deduction, elect to capitalize the portion of such circulation expenditures which is properly chargeable to capital account. As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; conversely, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by a taxpayer to treat any portion of his circulation expenditures as chargeable to capital account, the election must apply to all such expenditures which are properly so chargeable. In such case, no deduction shall be allowed under section 173 for any such expenditures. In particular cases, the extent to which any deductions attributable to the amortization of capital expenditures are allowed may be determined under sections 162, 263, and 461.

(2) A taxpayer may make the election referred to in subparagraph (1) of this paragraph by attaching a statement to his return for the first taxable year to which the election is applicable. Once an election is made, the taxpayer must continue in subsequent taxable years to charge to capital account all circulation expenditures properly so chargeable, unless the Commissioner, on application made to him in writing by the taxpayer, permits a revocation of such election for any subsequent taxable year or years. Permission to revoke such election may be granted subject to such conditions as the Commissioner deems necessary.

(3) Elections filed under section 23(bb) of the Internal Revenue Code of 1939 shall be given the same effect as if they were filed under section 173. (See section 7807(b)(2).)

#### § 1.174 STATUTORY PROVISIONS; RESEARCH AND EXPERIMENTAL EXPENDITURES.

##### SEC. 174. RESEARCH AND EXPERIMENTAL EXPENDITURES.

###### (a) TREATMENT AS EXPENSES.—

(1) IN GENERAL.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year

in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) WHEN METHOD MAY BE ADOPTED.—

(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this subsection for his first taxable year—

- (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and
- (ii) for which expenditures described in paragraph (1) are paid or incurred.

(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this subsection.

(3) SCOPE.—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

(b) AMORTIZATION OF CERTAIN RESEARCH AND EXPERIMENTAL EXPENDITURES.—

(1) IN GENERAL.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, research or experimental expenditures which are—

(A) paid or incurred by the taxpayer in connection with his trade or business,

(B) not treated as expenses under subsection (a), and

(C) chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion),

may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property).

(2) TIME FOR AND SCOPE OF ELECTION.—The election provided by paragraph (1) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

(c) LAND AND OTHER PROPERTY.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

(d) EXPLORATION EXPENDITURES.—This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e) CROSS REFERENCE.—For adjustments to basis of property for amounts



allowed as deductions as deferred expenses under subsection (b), see section 1016(a) (14).

§ 1.174-1 RESEARCH AND EXPERIMENTAL EXPENDITURES; IN GENERAL.—Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (see § 1.174-3), or they may be deferred and amortized (see § 1.174-4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See § 1.174-2 for the definition of research and experimental expenditures. The term “paid or incurred”, as used in section 174 and in §§ 1.174-1 to 1.174-4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a) (25).

§ 1.174-2 DEFINITION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.—(a) *In general.*—(1) The term “research or experimental expenditures”, as used in section 174, means expenditures incurred in connection with the taxpayer’s trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term includes the costs of obtaining a patent, such as attorneys’ fees expended in making and perfecting a patent application. On the other hand, the term does not include the cost of acquiring another’s patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

(2) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer’s behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(3) The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

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*Example (1).* A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of \$150,000 of which \$25,000 represents an addition to B's laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B's laboratory which will be retained by B. A may treat the entire \$150,000 as expenditures under section 174.

*Example (2).* X Corporation, a manufacturer of explosives, contracts with the Y research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, Y is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the cost of the tract of land and improvements.

(b) *Certain expenditures with respect to land and other property.*—

(1) Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in § 1.174-4(a) (4).

(3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be

capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.

(4) The deductions referred to in subparagraphs (2) and (3) of this paragraph for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. For the purpose of the preceding sentence, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property.

For example, a taxpayer undertakes to develop a new machine for use in his business. He expends \$30,000 on the project of which \$10,000 represents the actual costs of material, labor, etc., to construct the machine, and \$20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the \$20,000 as expenses not chargeable to capital account, but the \$10,000 must be charged to the asset account (the machine).

(c) *Exploration expenditures.*—The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas, or other mineral. See sections 615 and 263.

§ 1.174-3 TREATMENT AS EXPENSES.—(a) *In general.*—Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174(a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174(a)(3) with respect to part or all of the expenditures. See paragraph (b)(3) of this section. Thus, if a change to the deferred expense method under section 174(b) is authorized by the Commissioner with respect to research or experimental expenditures attributable to a particular project or projects, the taxpayer, for the taxable year of the change and for subsequent taxable years, must apply the deferred expense method to all such expenditures paid or incurred during any of those taxable years in connection with the particular project or projects, even though all other research and experimental expenditures are required to be

deducted as current expenses under this section. In no event will the taxpayer be permitted to adopt the method described in this section as to part of the expenditures relative to a particular project and adopt for the same taxable year a different method of treating the balance of the expenditures relating to the same project.

(b) *Adoption and change of method.*—(1) *Adoption without consent.*—The method described in this section may be adopted for any taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first such taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174(a)(2)(B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) *Adoption with consent.*—A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174(a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T: R, Washington 25, D. C. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which the adoption of the method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(3) *Change of method.*—An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T: R, Washington 25, D. C. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is to apply. See, however, subparagraph (4) of this paragraph, relating to extensions of time. The application shall—

- (i) State the first year to which the requested change is to be applicable;
- (ii) State whether the change is to apply to all research or experimental expenditures paid or incurred by the taxpayer, or only to expenditures attributable to a particular project or projects;
- (iii) Include such information as will identify the project or projects to which the change is applicable;

(iv) Indicate the number of months (not less than 60) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under section 174(b);

(v) State that, upon approval of the application, the taxpayer will make an accounting segregation on his books and records of the research or experimental expenditures to which the change in method is to apply; and

(vi) State the reasons for the change.

If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.

(4) *Special rules.*—If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 174 (a) is applicable falls before the ninetieth day after the date the regulations under section 174 are published in the Federal Register, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before such ninetieth day, must submit to the district director for the district in which the return was filed the information required by subparagraph (3) of this paragraph. For any taxable year for which the expense method or a different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before such ninetieth day if such return is necessary.

§ 1.174-4 TREATMENT AS DEFERRED EXPENSES.—(a) *In general.*—

(1) If a taxpayer has not adopted the method provided in section 174(a) of treating research or experimental expenditures paid or incurred by him in connection with his trade or business as currently deductible expenses, he may, for any taxable year beginning after December 31, 1953, elect to treat such expenditures as deferred expenses under section 174(b), subject to the limitations of subparagraph (2) of this paragraph. If a taxpayer has adopted the method of treating such expenditures as expenses under section 174(a), he may not elect to defer and amortize any such expenditures unless permission to do so is granted under section 174(a) (3). See paragraph (b) of this section.

(2) The election to treat research or experimental expenditures as deferred expenses under section 174 (b) applies only to those expenditures which are chargeable to capital account but which are not chargeable to property of a character subject to an allowance for depreciation or depletion under section 167 or 611, respectively. Thus, the election under section 174(b) applies only if the property resulting from the research or experimental expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174(b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016 (a) (1), relating to adjustments to basis of property. See section 1016(a) (14). See section 174(c) and § 1.174-2(b) (1) for treatment of expenditures

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for the acquisition or improvement of land or of depreciable or depletable property to be used in connection with the research or experimentation.

(3) Expenditures which are treated as deferred expenses under section 174(b) are allowable as a deduction ratably over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures. The length of the period shall be selected by the taxpayer at the time he makes the election to defer the expenditures. If a taxpayer has two or more separate projects, he may select a different amortization period for each project. In the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use. See section 1016(a)(14) for adjustments to basis of property for amounts allowed as deductions under section 174(b) and this section. See section 165 and the regulations thereunder for rules relating to the treatment of losses resulting from abandonment.

(4) If expenditures which the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174(b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. For example, for the taxable year 1954, A, who reports his income on the basis of a calendar year, elects to defer and deduct ratably over a period of 60 months research and experimental expenditures made in connection with a particular project. In 1956, the total of the deferred expenditures amounts to \$60,000. At that time, A has developed a process which he seeks to patent. On July 1, 1956, A first realized benefits from the marketing of products resulting from this process. Therefore, the expenditures deferred are deductible ratably over the 60-month period beginning with July 1, 1956 (when A first realized benefits from the project). In his return for the year 1956, A deducted \$6,000; in 1957, A deducted \$12,000 (\$1,000 per month). On July 1, 1958, a patent protecting his process is obtained by A. In his return for 1958, A is entitled to a deduction of \$6,000, representing the amortizable portion of the deferred expenses attributable to the period prior to July 1, 1958. The balance of the unrecovered expenditures (\$60,000 minus \$24,000, or \$36,000) is to be recovered as a depreciation deduction over the life of the patent commencing with July 1, 1958. Thus, one-half of the annual depreciation deduction based upon the useful life of the patent is also deductible for 1958 (from July 1 to December 31).

(5) The election shall be applicable to all research and experimental expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to the particular project, subject to the limitations of subparagraph (2) of this paragraph. The election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner

under section 174(b)(2). See paragraph (b)(2) of this section. Likewise, the taxpayer shall adhere to the amortization period selected at the time of the election unless a different period of amortization with respect to a part of all of the expenditures is similarly authorized. However, no change in method will be permitted with respect to expenditures paid or incurred before the taxable year to which the change is to apply. In no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174(b) and to adopt a different method of treating the balance of the expenditures relating to the same project for the same taxable year. The election under this section shall not apply to any expenditures paid or incurred before the taxable year for which the taxpayer makes the election.

(b) *Election and change of method.*—(1) *Election.*—The election under section 174(b) shall be made not later than the time (including extensions) prescribed by law for filing the return for the taxable year for which the method is to be adopted. The election shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall be signed by the taxpayer (or his duly authorized representative), and shall—

(i) Set forth the name and address of the taxpayer;

(ii) Designate the first taxable year to which the election is to apply;

(iii) State whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects, and, if the latter, include such information as will identify the project or projects as to which the election is to apply;

(iv) Set forth the amount of all research or experimental expenditures paid or incurred during the taxable year for which the election is made;

(v) Indicate the number of months (not less than 60) selected for amortization of the deferred expenses for each project; and

(vi) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(2) *Change to a different method or period.*—Application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D. C. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the end of the first taxable year in which the different method or different amortization period is to be used (unless subparagraph (3) of this paragraph, relating to extensions of time, is applicable). The application shall set forth the following information with regard to the research or experimental expenditures which are being treated under section 174(b) as deferred expenses:

(i) Total amount of research or experimental expenditures attributable to each project;

(ii) Amortization period applicable to each project; and

(iii) Unamortized expenditures attributable to each project at the beginning of the taxable year in which the application is filed. In addition, the application shall set forth the length of the new period or periods proposed, or the new method of treatment proposed, the reasons for the proposed change, and such information as will identify the project or projects to which the expenditures affected by the change relate. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting the permission to his income tax return for the first taxable year in which the different method or period is to be effective.

(3) *Special rules.*—If the last day prescribed by law for filing a return for any taxable year for which the deferred method provided in section 174 (b) has been adopted falls before the ninetieth day after the date the regulations under section 174 are published in the Federal Register, consent is hereby given for the taxpayer to change from such method and adopt a different method of treating research or experimental expenditures, provided that on or before such ninetieth day he submits to the district director for the district in which the return was filed the information required by subparagraph (2) of this paragraph, relating to a change to a different method or period. For any taxable year for which the different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before such ninetieth day.

(c) *Example.*—The application of this section is illustrated by the following example:

*Example.* N Corporation is engaged in the business of manufacturing chemical products. On January 1, 1955, work is begun on a special research project. N Corporation elects, pursuant to section 174(b), to defer the expenditures relating to the special project and to amortize the expenditures over a period of 72 months beginning with the month in which benefits from the expenditures are first realized. On January 1, 1955, N Corporation also purchased for \$57,600 a building having a remaining useful life of 12 years as of the date of purchase and no salvage value at the end of the period. Fifty percent of the building's facilities are to be used in connection with the special research project. During 1955, N Corporation pays or incurs the following expenditures relating to the special research project:

Salaries .....	\$15,000
Heat, light, and power .....	700
Drawings .....	2,000
Models .....	6,500
Laboratory materials .....	8,000
Attorneys' fees .....	1,400
Depreciation on building attributable to project (50% of \$4,800 allowable depreciation) .....	2,400

Total research and development expenditures..... \$36,000

The above expenditures result in a process which is marketable but not patentable and which has no determinable useful life. N Corporation



first realizes benefits from the process in January 1956. N Corporation is entitled to deduct the amount of \$6,000  $\left( \frac{\$36,000 \times 12 \text{ months}}{72 \text{ months}} \right)$  as deferred expenses under section 174(b) in computing taxable income for 1956.

## § 1.175 STATUTORY PROVISIONS; SOIL AND WATER CONSERVATION EXPENDITURES.

### SEC. 175. SOIL AND WATER CONSERVATION EXPENDITURES.

(a) **IN GENERAL.**—A taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(b) **LIMITATION.**—The amount deductible under subsection (a) for any taxable year shall not exceed 25 percent of the gross income derived from farming during the taxable year. If for any taxable year the total of the expenditures treated as expenses which are not chargeable to capital account exceeds 25 percent of the gross income derived from farming during the taxable year, such excess shall be deductible for succeeding taxable years in order of time; but the amount deductible under this section for any one such succeeding taxable year (including the expenditures actually paid or incurred during the taxable year) shall not exceed 25 percent of the gross income derived from farming during the taxable year.

(c) **DEFINITIONS.**—For purposes of subsection (a)—

(1) The term “expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming” means expenditures paid or incurred for the treatment or moving of earth, including (but not limited to) leveling, grading and terracing, contour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of windbreaks. Such term does not include—

(A) the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) any amount paid or incurred which is allowable as a deduction without regard to this section.

Notwithstanding the preceding sentences, such term also includes any amount, not otherwise allowable as a deduction, paid or incurred to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district which, if paid or incurred by the taxpayer, would without regard to this sentence constitute expenditures deductible under this section.

(2) The term “land used in farming” means land used (before or simultaneously with the expenditures described in paragraph (1)) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

(d) **WHEN METHOD MAY BE ADOPTED.**—

(1) **WITHOUT CONSENT.**—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this section for his first taxable year—

(A) which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(B) for which expenditures described in subsection (a) are paid or incurred.

(2) **WITH CONSENT.**—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this section.

(e) SCOPE.—The method adopted under this section shall apply to all expenditures described in subsection (a). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

§ 1.175-1 SOIL AND WATER CONSERVATION EXPENDITURES; IN GENERAL.—Under section 175, a farmer may deduct his soil or water conservation expenditures which do not give rise to a deduction for depreciation and which are not otherwise deductible. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, he must deduct all such expenditures (subject to the 25-percent limitation) for the current and subsequent taxable years. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate.

§ 1.175-2 DEFINITION OF SOIL AND WATER CONSERVATION EXPENDITURES.—(a) *Expenditures treated as a deduction.*—(1) The method described in section 175 applies to expenditures paid or incurred for the purpose of soil or water conservation in respect of land used in farming or for the prevention of erosion of land used in farming, but only if such expenditures are made in the furtherance of the business of farming. More specifically, a farmer may deduct expenditures made for these purposes which are for (i) the treatment or moving of earth, (ii) the construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds, (iii) the eradication of brush, and (iv) the planting of windbreaks. Expenditures for the treatment or moving of earth include but are not limited to expenditures for leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility.

(2) The following are examples of soil and water conservation: (i) Constructing terraces, or the like, to detain or control the flow of water, to check soil erosion on sloping land, to intercept run-off, and to divert excess water to protected outlets; (ii) constructing water detention or sediment retention dams to prevent or fill gullies, to retard or reduce run-off of water, or to collect stock water; and (iii) constructing earthen floodways, levies, or dikes, to prevent flood damage to farmland.

(b) *Expenditures not subject to section 175 treatment.*—(1) The method described in section 175 applies only to expenditures for non-depreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities subject to the allowance for depreciation. Thus, the method does not apply to depreciable non-earthen items such as those made of masonry or concrete (see section 167). For example, expenditures in respect of depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete,

tile, metal, or wood. Similarly, the method is not applicable to expenditures for fertilizer effective substantially longer than one year, since such expenditures are also depreciable. However, the method applies to expenditures for earthen items which are not subject to a depreciation allowance. For example, expenditures for earthen terraces and dams which are nondepreciable are deductible under section 175.

(2) The method does not apply to expenses deductible apart from section 175. Adoption of the method is not necessary in order to deduct such expenses in full without limitation. Thus, the method does not apply to interest (deductible under section 163), nor to taxes (deductible under section 164). It does not apply to expenses for the repair of completed soil or water conservation structures, such as costs of annual removal of sediment from a drainage ditch. It does not apply to expenditures paid or incurred primarily to produce an agricultural crop even though they incidentally conserve soil. Thus, the cost of fertilizer (the effectiveness of which does not last beyond one year) used to produce hay is deductible without adoption of the method described in section 175. However, the method would apply to expenses incurred to produce vegetation primarily to conserve soil or water or to prevent erosion. Thus, for example, the method would apply to such expenditures as the cost of dirt moving, lime, fertilizer, seed and planting stock used in gully stabilization, or in stabilizing severely eroded areas, in order to obtain a soil binding stand of vegetation on raw or infertile land.

(c) *Assessments*.—The method applies also to that part of assessments levied by a soil or water conservation or drainage district to reimburse it for its expenditures which, if actually paid or incurred during the taxable year by the taxpayer directly, would be deductible under section 175. Depending upon the farmer's method of accounting, the time when the farmer pays or incurs the assessment, and not the time when the expenditures are paid or incurred by the district, controls the time the deduction must be taken. The provisions of this paragraph may be illustrated by the following example:

*Example.* In 1955 a soil and water conservation district levies an assessment of \$700 upon a farmer on the cash method of accounting. The assessment is to reimburse the district for its expenditures in 1954. The farmer's share of such expenditures is as follows: \$400 for digging drainage ditches for soil conservation and \$300 for assets subject to the allowance for depreciation. If the farmer pays the assessment in 1955 and has adopted the method of treating expenditures for soil or water conservation as current expenses under section 175, he may deduct in 1955 the \$400 attributable to the digging of drainage ditches as a soil conservation expenditure subject to the 25-percent limitation.

§ 1.175-3 DEFINITION OF "THE BUSINESS OF FARMING".—The method described in section 175 is available only to a taxpayer engaged in "the business of farming". A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon

farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term "farm" is used in its ordinary, accepted sense and includes stock, dairy, poultry, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A taxpayer is engaged in "the business of farming" if he is a member of a partnership engaged in the business of farming. See § 1.702-1 (a) (8) (i) and (c) (1) (iv).

§ 1.175-4 DEFINITION OF "LAND USED IN FARMING".—(a) For the purpose of section 175, the term "land used in farming" means land which is used in the business of farming and which meets both of the following requirements:

(1) The land must be used for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. It does not include fish, frogs, reptiles, and the like. Land used for the sustenance of livestock includes land used for grazing such livestock.

(2) The land must be or have been so used either by the taxpayer or his tenant at some time before, or at the same time as, the taxpayer makes the expenditures for soil or water conservation or for the prevention of the erosion of land. The taxpayer will be considered to have used the land in farming before making such expenditures if he or his tenant has employed the land in a farming use in the past. If the expenditures are made by the taxpayer in respect of land newly acquired from one who immediately prior to the acquisition was using it in farming, the taxpayer will be considered to be using the land in farming at the time that such expenditures are made, if the use which is made by the taxpayer of the land from the time of its acquisition by him is substantially a continuation of the use which was made of the land immediately prior to its acquisition. On the other hand, if the land is being initially prepared by the taxpayer in order to make it suitable for a particular farming use other than the one to which the land was devoted prior to its acquisition by the taxpayer, such land is not considered to be "land used in farming" at the time of its preparation.

(b) The provisions of paragraph (a) of this section may be illustrated by the following examples:

*Example (1).* A purchases an operating farm from B in the autumn after B has harvested his crops. At the time of such purchase the land is suitable for A's particular farming use without the necessity of making initial preparatory expenditures. Prior to spring plowing and planting when the land is idle because of the season, A makes certain soil and water conservation expenditures on this farm. At the time such expenditures are made the land is

considered to be used by A in farming, and A may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

*Example (2).* C acquires uncultivated land which he intends to develop for farming. Prior to putting this land into production it is necessary for C to clear brush, construct earthen terraces and ponds, and make other soil and water conservation expenditures. The land is not used in farming at the same time that such expenditures are made. Therefore, C may not deduct such expenditures under section 175.

*Example (3).* D acquires several tracts of land from persons who had used such land for grazing cattle. D intends to use the land for a citrus grove. In order to make the land suitable for this use, D constructs earthen terraces, builds drainage ditches and irrigation ditches, extensively treats the soil, and makes other soil and water conservation expenditures. The land is not used in farming by D at the time he makes such expenditures, but is being initially prepared for use as a citrus grove. Therefore, D may not deduct such expenditures under section 175.

§ 1.175-5 PERCENTAGE LIMITATION AND CARRYOVER.—(a) *The limitation.*—(1) *General rule.*—The amount of soil and water conservation expenditures which the taxpayer may deduct under section 175 in any one taxable year is limited to 25 percent of his “gross income from farming.”

(2) *Definition of “gross income from farming.”*—For the purpose of section 175, the term “gross income from farming” means the gross income of the taxpayer, derived in “the business of farming” as defined in § 1.175-3, from the production of crops, fruits, or other agricultural products or from livestock (including livestock held for draft, breeding, or dairy purposes). It includes such income from land used in farming other than that upon which expenditures are made for soil or water conservation or for the prevention of erosion of land. It does not include gains from sales of assets such as farm machinery or gains from the disposition of land. A taxpayer shall compute his “gross income from farming” in accordance with his accounting method used in determining gross income. (See the regulations under section 61 relating to accounting methods used by farmers in determining gross income.) The provisions of this subparagraph may be illustrated by the following example:

*Example.* A, who uses the cash receipts and disbursements method of accounting, includes in his “gross income from farming” for purposes of determining the 25-percent limitation the following items:

Proceeds from sale of his 1955 yield of corn.....	\$10,000
Gain from disposition of old breeding cows replaced by younger cows..	500
Total gross income from farming.....	<u>\$10,500</u>

A must exclude from "gross income from farming" the following items which are included in his gross income:

Gain from sale of tractor.....	\$100
Gain from sale of 40 acres of taxpayer's farm.....	8,000
Interest on loan to neighboring farmer.....	100

(3) *Deduction qualifies for net operating loss deduction.*—Any amount allowed as a deduction under section 175, either for the year in which the expenditure is paid or incurred or for the year to which it is carried, is taken into account in computing a net operating loss for such taxable year. If a deduction for soil or water conservation expenditures has been taken into account in computing a net operating loss carryback or carryover, it shall not be considered a soil or water conservation expenditure for the year to which the loss is carried, and, therefore, is not subject to the 25-percent limitation for that year. The provisions of this subparagraph may be illustrated by the following example:

*Example.* Assume that in 1956 A has gross income from farming of \$4,000, soil and water conservation expenditures of \$1,600, and deductible farm expenses of \$3,500. Of the soil and water conservation expenditures, \$1,000 is deductible in 1956. The \$600 in excess of 25 percent of A's gross income from farming is carried over into 1957. Assuming that A has no other income, his deductions of \$4,500 (\$1,000 plus \$3,500) exceed his gross income of \$4,000 by \$500. This \$500 will constitute a net operating loss which he must carry back two years and carry forward five years, until it has offset \$500 of taxable income. No part of this \$500 net operating loss carryback or carryover will be taken into account in determining the amount of soil and water conservation expenditures in the years to which it is carried.

(b) *Carryover of expenditures in excess of deduction.*—The deduction for soil and water conservation expenditures in any one taxable year is limited to 25 percent of the taxpayer's gross income from farming. The taxpayer may carry over the excess of such expenditures over 25 percent of his gross income from farming into his next taxable year, and, if not deductible in that year, into the next year, and so on without limit as to time. In determining the deductible amount of such expenditures for any taxable year, the actual expenditures of that year shall be added to any such expenditures carried over from prior years, before applying the 25-percent limitation. Any such expenditures in excess of the deductible amount may be carried over during the taxpayer's entire existence. For this purpose in a farm partnership, since the 25-percent limitation is applied to each partner, not the partnership, the carryover may be carried forward during the life of the partner. The provisions of this paragraph may be illustrated by the following example:

*Example.* Assume the expenditures and income shown in the following table:

		<i>Deductible soil and water conservation expenditures</i>			
		<i>Paid or incurred during taxable year</i>	<i>Carried forward from prior year</i>	<i>Total</i>	
<i>Year</i>					<i>25% of gross income from farming</i>
1954	.....	\$900	None	\$900	\$800
1955	.....	1,000	\$100	1,100	900
1956	.....	None	200	200	1,000
					<i>Excess to be carried forward</i>
					\$100
					200
					None

The deduction for 1954 is limited to \$800. The remainder, \$100 (\$900 minus \$800), not being deductible for 1954, is a carryover to 1955. For 1955, accordingly, the total of the expenditures to be taken into account is \$1,100 (the \$100 carryover and the \$1,000 actually paid in that year). The deduction for 1955 is limited to \$900, and the remainder of the \$1,100 total, or \$200, is a carryover to 1956. The deduction for 1956 consists solely of this carryover of \$200. Since the total expenditures, actual and carried over, for 1956 are less than 25 percent of gross income from farming, there is no carryover into 1957.

§ 1.175-6 ADOPTION OR CHANGE OF METHOD.—(a) *Adoption without consent.*—A taxpayer may, without consent, adopt the method of treating expenditures for soil or water conservation as expenses for the first taxable year:

(1) Which begins after December 31, 1953, and ends after August 16, 1954, and

(2) For which soil or water conservation expenditures described in section 175(a) are paid or incurred.

Such adoption shall be made by claiming the deduction on his income tax return. For a taxable year ending prior to the adoption of regulations under this section, the adoption of the method described in section 175 shall be made by claiming the deduction on such return for that year, or by claiming the deduction on an amended return filed for that year within 90 days after the date of publication (following adoption) of such regulations in the Federal Register.

(b) *Adoption with consent.*—A taxpayer may adopt the method of treating soil and water conservation expenditures as provided by section 175 for any taxable year to which the section is applicable if consent is obtained from the district director for the district in which the taxpayer's return is required to be filed.

(c) *Change of method.*—A taxpayer who has adopted the method of treating expenditures for soil or water conservation, as provided by section 175, may change from this method and capitalize such expenditures made after the effective date of the change, if he obtains the consent of the district director for the district in which his return is required to be filed.

(d) *Request for consent to adopt or change method.*—Where the consent of the district director is required under paragraph (b) or (c) of this section, the request for his consent shall be in writing, signed by the taxpayer or his authorized representative, and shall be

filed not later than the date prescribed by law for filing the income tax return for the first taxable year to which the adoption of, or change of, method is to apply, or not later than 90 days after the date of publication in the Federal Register of the regulations under section 175 following their adoption, whichever is later. The request shall—

- (1) Set forth the name and address of the taxpayer;
- (2) Designate the first taxable year to which the method or change of method is to apply;
- (3) State whether the method or change of method is intended to apply to all expenditures within the permissible scope of section 175, or only to a particular project or farm and, if the latter, include such information as will identify the project or farm as to which the method or change of method is to apply;
- (4) Set forth the amount of all soil and water conservation expenditures paid or incurred during the first taxable year for which the method or change of method is to apply; and
- (5) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(e) *Scope of method.*—Except with the consent of the district director as provided in paragraph (b) or (c) of this section, the taxpayer's method of treating soil and water conservation expenditures described in section 175 shall apply to all such expenditures for the taxable year of adoption and all subsequent taxable years. Although a taxpayer may have elected to deduct soil and water conservation expenditures, he may request an authorization to capitalize his soil and water conservation expenditures attributable to a special project or single farm. Similarly, a taxpayer who has not elected to deduct such expenditures may request an authorization to deduct his soil and water conservation expenditures attributable to a special project or single farm. The authorization with respect to the special project or single farm will not affect the method adopted with respect to the taxpayer's regularly incurred soil and water conservation expenditures. No adoption of, or change of, the method under section 175 will be permitted as to expenditures actually paid or incurred before the taxable year to which the method or change of method is to apply. Thus, if a taxpayer adopts such method for 1956, he cannot deduct any part of such expenditures which he capitalized, or should have capitalized, in 1955. Likewise, if a taxpayer who has adopted such method has an unused carryover of such expenditures in excess of the 25-percent limitation, and is granted consent to capitalize soil and water conservation expenditures beginning in 1956, he cannot capitalize any part of the unused carryover. The excess expenditures carried over continue to be deductible to the extent of 25 percent of the taxpayer's gross income from farming. No adjustment to the basis of land shall be made under section 1016 for expenditures to which the method under section 175 applies. For example, A has an unused carryover of soil and water conservation expenditures amounting to \$5,000 as of December 31, 1956. On January 1, 1957, A sells his farm and goes out of the business of farming. The unused carryover of \$5,000 cannot be added to the basis of the farm for purposes of determining gain or loss on its sale. In 1959, A purchases another



farm and resumes the business of farming. In such year, A may deduct the amount of the unused carryover to the extent of 25 percent of his gross income from farming and may carry over any excess to subsequent years.

#### ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

##### § 1.211 STATUTORY PROVISIONS; ALLOWANCE OF DEDUCTIONS.

##### SEC. 211. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible).

§ 1.211-1 ALLOWANCE OF DEDUCTIONS.—In computing taxable income under section 63(a), the deductions provided by sections 212, 213, 214, 215, and 216 shall be allowed subject to the exceptions provided in part IX (section 261 and following, related to items not deductible).

##### § 1.212 STATUTORY PROVISIONS; EXPENSES FOR PRODUCTION OF INCOME.

##### SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

- (1) for the production or collection of income;
- (2) for the management, conservation, or maintenance of property held for the production of income; or
- (3) in connection with the determination, collection, or refund of any tax.

§ 1.212-1 NONTRADE OR NONBUSINESS EXPENSES.—(a) An expense may be deducted under section 212 only if—

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includable in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes

are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

(c) Expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

(d) Expenses, to be deductible under section 212, must be "ordinary and necessary". Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in sections 261 through 273, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Internal Revenue Code of 1954, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

(f) Among expenditures not allowable as deductions under section 212 are the following: Commuter's expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses paid or incurred in securing admission to the bar, and corresponding fees and expenses paid or incurred by physicians, dentists, accountants,

and other taxpayers for securing the right to practice their respective professions. See, however, section 162 and the regulations thereunder.

(g) Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

(j) Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

(1) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus,

expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Internal Revenue Code of 1954 to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Internal Revenue Code of 1954.

(o) The provisions of section 212 are not intended in any way to disallow expenses which would otherwise be allowable under section 162 and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.

## § 1.213 STATUTORY PROVISIONS; MEDICAL, DENTAL, ETC., EXPENSES.

### SEC. 213. MEDICAL, DENTAL, ETC., EXPENSES.

(a) ALLOWANCE OF DEDUCTION.—There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152)—

(1) if neither the taxpayer nor his spouse has attained the age of 65 before the close of the taxable year, to the extent that such expenses exceed 3 percent of the adjusted gross income; or

(2) if either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year—

(A) the amount of such expenses for the care of the taxpayer and his spouse, and

(B) the amount by which such expenses for the care of such dependents exceed 3 percent of the adjusted gross income.

(b) LIMITATION WITH RESPECT TO MEDICINE AND DRUGS.—Amounts paid during the taxable year for medicine and drugs which (but for this subsection) would be taken into account in computing the deduction under subsection (a) shall be taken into account only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income.

(c) MAXIMUM LIMITATIONS.—The deduction under this section shall not exceed \$2,500, multiplied by the number of exemptions allowed for the taxable year as a deduction under section 151 (other than exemptions allowed by reason of subsection (c) or (d), relating to additional exemptions for age or blindness); except that the maximum deduction under this section shall be—

(1) \$5,000, if the taxpayer is single and not the head of a household (as defined in section 1 (b) (2)) and not a surviving spouse (as defined in section 2 (b)) or is married but files a separate return; or

(2) \$10,000, if the taxpayer files a joint return with his spouse under

section 6013, or is the head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)).

(d) SPECIAL RULE FOR DECEDENTS.—

(1) TREATMENT OF EXPENSES PAID AFTER DEATH.—For purposes of subsection (a), expenses for the medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred.

(2) LIMITATION.—Paragraph (1) shall not apply if the amount paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent, but this paragraph shall not apply if (within the time and in the manner and form prescribed by the Secretary or his delegate) there is filed—

(A) a statement that such amount has not been claimed or allowed as a deduction under section 2053, and

(B) a waiver of the right to have such amount allowed at any time as a deduction under section 2053.

(e) DEFINITIONS.—For purposes of this section—

(1) The term “medical care” means amounts paid—

(A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or

(B) for transportation primarily for and essential to medical care referred to in subparagraph (A).

(2) The determination of whether an individual is married at any time during the taxable year shall be made in accordance with the provisions of section 6013 (d) (relating to determination of status as husband and wife).

(f) EXCLUSION OF AMOUNTS ALLOWED FOR CARE OF CERTAIN DEPENDENTS.—Any expense allowed as a deduction under section 214 shall not be treated as an expense paid for medical care.

§ 1.213-1 MEDICAL, DENTAL, ETC., EXPENSES.—(a) *Allowance of deduction.*—(1) Section 213 permits a deduction of payments for certain medical expenses (including expenses for medicine and drugs). Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year.

(2) Except as provided in subparagraph (4) (i) of this paragraph, only such medical expenses (including the allowable expenses for medicine and drugs) are deductible as exceed 3 percent of the adjusted gross income for the taxable year. For the amount paid during the taxable year for medicine and drugs which may be taken into account in computing total medical expenses, see paragraph (b) of this section. For the maximum deduction allowable under section 213, see paragraph (c) of this section. As to what constitutes “adjusted gross income”, see section 62 and the regulations thereunder.

(3) (i) For medical expenses paid (including expenses paid for medicine and drugs) to be deductible, they must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer and not be compensated for by insurance or otherwise. See section 152 and the regulations thereunder for definition of a dependent.

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(ii) An amount excluded from gross income under section 105 (c) or (d) (relating to amounts received under accident and health plans) and the regulations thereunder shall not constitute compensation for expenses paid for medical care. Exclusion of such amounts from gross income will not affect the treatment of expenses paid for medical care.

(iii) The application of the rule allowing a deduction for medical expenses to the extent not compensated for by insurance or otherwise may be illustrated by the following example in which it is assumed that neither the taxpayer nor his wife has attained the age of 65:

*Example.* Taxpayer H, married to W and having one dependent child, had adjusted gross income for 1956 of \$3,000. During 1956 he paid \$300 for medical care, of which \$100 was for treatment of his dependent child and \$200 for an operation on W which was performed in September 1955. In 1956 he received a payment of \$50 for health insurance to cover a portion of the cost of W's operation performed during 1955. The deduction allowable under section 213 for the calendar year 1956, provided the taxpayer itemizes his deductions and does not compute his tax under section 3 by use of the tax table, is \$160, computed as follows:

Payments in 1956 for medical care.....	\$300
Less: Amount of insurance received in 1956.....	50
Payments in 1956 for medical care not compensated for during 1956....	\$250
Less: 3 percent of \$3,000 (adjusted gross income).....	90
Excess, allowable as a deduction for 1956.....	\$160

(4) (i) Where either the taxpayer or his spouse has attained the age of 65 before the end of the taxable year, the 3-percent limitation on the deduction for medical expenses does not apply with respect to expenses for the medical care of the taxpayer or his spouse. In such a case the taxpayer may deduct, subject to the 1-percent limitation with respect to medicine and drugs set forth in paragraph (b) of this section and subject to the maximum amount allowable as described in paragraph (c) of this section—

(a) The amount of all payments for the medical care of the taxpayer and his spouse, and

(b) The amount by which his payments for the medical care of his dependents exceed 3 percent of his adjusted gross income. In determining the amount described in subdivision (i) (b) of this subparagraph, the amount described in subdivision (i) (a) of this subparagraph shall not be taken into account.

(ii) For the purposes of this subparagraph, the age of a taxpayer shall be determined as of the last day of his taxable year. In the event of the taxpayer's death, the date of his death shall be the last day of his taxable year. The age of a taxpayer's spouse shall be determined as of the last day of the taxpayer's taxable year, except that, if the spouse dies within such taxable year, her age shall be determined as of the date of her death.

(iii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

*Example (1).* Taxpayer A, who attained the age of 65 on February 22, 1956, makes his return on the basis of the calendar year.

During the year 1956, A had adjusted gross income of \$8,000, and paid the following medical bills: (a) \$560 (7 percent of adjusted gross income) for the medical care of himself and his spouse, and (b) \$160 (2 percent of adjusted gross income) for the medical care of his dependent son. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for 1956 is \$560, the full amount of the medical expenses for the taxpayer and his spouse. No deduction is allowable for the amount of \$160 paid for medical care of the dependent son since the amount of such payment (determined without regard to the payments for the care of the taxpayer and his spouse) does not exceed 3 percent of adjusted gross income.

*Example (2).* H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on August 15, 1956. The adjusted gross income of H and W in 1956 was \$40,000 and they paid in such year the following amounts for medical care: (a) \$3,000 for the medical care of H; (b) \$2,000 for the medical care of W; and (c) \$3,000 for the medical care of the dependent child. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1956 is \$6,800 computed as follows:

Payments for medical care of H and W in 1956.....	\$5,000
Payments for medical care of the dependent in 1956.....	\$3,000
Less: 3 percent of \$40,000 (adjusted gross income).....	1,200
Allowable deduction for 1956.....	<u>\$6,800</u>

(b) *Limitation with respect to medicine and drugs.*—(1) Amounts paid for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction. For definition of medicine and drugs, see paragraph (e) (2) of this section. The application of this subparagraph may be illustrated by the following example:

*Example.* The taxpayer, a single individual with no dependents, had an adjusted gross income of \$6,000 for the calendar year 1956. During 1956, he paid a doctor \$300 for medical services, a hospital \$100 for hospital care, and also spent \$100 for medicine and drugs. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is \$260, computed as follows:

Payments for medical care in 1956:	
Doctor .....	\$300
Hospital .....	100
Medicine and drugs .....	\$100
Less: 1 percent of \$6,000 (adjusted gross income).....	60
Total medical expenses to be taken into account.....	<u>\$440</u>
Less: 3 percent of \$6,000 (adjusted gross income).....	180
Allowable deduction for 1956.....	<u>\$260</u>

(2) The 1-percent limitation rule is applicable to all taxpayers, including a taxpayer (or his spouse) who has attained the age of 65. In a case where either a taxpayer or his spouse has attained the age of 65 and the taxpayer pays an amount in excess of 1 percent of adjusted gross income for medicine and drugs for himself, his spouse, and his dependents, it is necessary to apportion the 1 percent of adjusted gross income (the portion which is not taken into account as expenses paid for medical care) between the taxpayer and his spouse on the one hand and his dependents on the other. The part of the 1 percent allocable to the taxpayer and his spouse is an amount which bears the same ratio to 1 percent of his adjusted gross income which the amount paid for medicine and drugs for the taxpayer and his spouse bears to the total amount paid for medicine and drugs for the taxpayer, his spouse, and his dependents. The balance of the 1 percent shall be allocated to his dependents. The amount paid for medicine and drugs in excess of the allocated part of the 1 percent shall be taken into account as payments for medical care for the taxpayer and his spouse on the one hand and his dependents on the other, respectively. The application of this subparagraph may be illustrated by the following example:

*Example.* H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on September 15, 1956. The adjusted gross income of H and W for 1956 is \$10,000. During the year, H and W paid the following amounts for medical care: (i) \$1,000 for doctors and hospital expenses and \$180 for medicine and drugs for themselves; and (ii) \$500 for doctors and hospital expenses and \$140 for medicine and drugs for the dependent child. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a) (2) for medical expenses paid in 1956 is \$1,420, computed as follows:

<i>H and W</i>		
Payments for doctors and hospital.....		\$1,000.00
Payments for medicine and drugs.....	\$180.00	
Less: Limitation for medicine and drugs (see computation below) .....	56.25	123.75
Medical expenses for H and W to be taken into account.....		<u>\$1,123.75</u>

<i>Dependent</i>		
Payments for doctors and hospital.....	\$500.00	
Payments for medicine and drugs.....	\$140.00	
Less: Limitation for medicine and drugs (see computation below) .....	43.75	96.25

Total medical expenses .....	\$596.25	
Less: 3 percent of \$10,000 (adjusted gross income) .....	300.00	
Medical expenses for the dependent to be taken into account.....		\$296.25
Allowable deduction for 1956.....		<u>\$1,420.00</u>

<i>Payments for medicine and drugs</i>		
H and W .....	\$180.00	
Dependent .....	140.00	
Total payments .....	\$320.00	
Less: 1 percent of \$10,000 (adjusted gross income) .....	100.00	
Payments to be taken into account.....		<u>220.00</u>



*Allocation of 1 percent exclusion*

H and W $\frac{180}{320} \times \$100 =$ .....	\$56.25
Dependent $\frac{140}{320} \times \$100 =$ .....	43.75
Total .....	<u>\$100.00</u>

(c) *Maximum limitations.*—(1) The maximum deduction allowable for medical expenses paid in any one taxable year is the lesser of:

(i) \$2,500 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151(c) for a taxpayer or spouse attaining the age of 65, or section 151(d) for a taxpayer who is blind or a spouse who is blind) ;

(ii) \$5,000, if the taxpayer is single, not the head of a household (as defined in section 1(b)(2)) and not a surviving spouse (as defined in section 2(b)), or is married and files a separate return; or

(iii) \$10,000, if the taxpayer is married and files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* H and W made a joint return for the calendar year 1956 and were allowed five exemptions (exclusive of exemptions under section 151 (c) or (d)), one for each taxpayer and three for their dependents. The adjusted gross income of H and W in 1956 was \$40,000. They paid during such year \$12,500 for medical care, no part of which is compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is \$10,000, computed as follows:

Payments for medical care in 1956.....	\$12,500
Less: 3 percent of \$40,000 (adjusted gross income).....	<u>1,200</u>

Excess of medical expenses in 1956 over 3 percent of adjusted gross income .....	\$11,300
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• Allowable deduction for 1956 (\$2,500 multiplied by 5 exemptions allowed under section 151 (b) and (e) but not in excess of \$10,000) ..	<u>10,000</u>
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(d) *Special rule for decedents.*—(1) For the purpose of section 213(a), expenses for medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time the medical services were rendered. However, no credit or refund of tax shall be allowed for any taxable year for which the statutory period for filing a claim has expired. See section 6511 and the regulations thereunder.

(2) The rule prescribed in subparagraph (1) of this paragraph shall not apply where the amount so paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent unless there is filed in duplicate (i) a statement that such amount has not been allowed as a deduction under section 2053 in computing the taxable estate of the decedent and (ii) a waiver of the right to

have such amount allowed at any time as a deduction under section 2053. The statement and waiver shall be filed with or for association with the return, amended return, or claim for credit or refund for the decedent for any taxable year for which such an amount is claimed as a deduction.

(e) *Definitions*.—(1) *General*.—(i) The term “medical care” includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for “medical care” shall include those paid for the purpose of affecting any structure or function of the body, for accident or health insurance, or for transportation primarily for and essential to medical care. Amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care. However, premiums paid by a taxpayer under an insurance contract which provides reimbursement for loss of earnings due to accident or illness do not constitute amounts expended for medical care. In the case of a policy providing reimbursement for both loss of earnings and medical expenses, only the pro rata portion of such premium payments which is properly attributable to the coverage for medical expenses will constitute an expense paid for medical care.

(ii) Amounts paid for operations or treatments affecting and portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Amounts expended for illegal operations or treatments are not deductible. Deductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: Hospital services, nursing services (including nurses’ board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine and drugs (as defined in subparagraph (2) of this paragraph, subject to the 1-percent limitation in paragraph (b) of this section), artificial teeth or limbs, and ambulance hire. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

(iii) A capital expenditure for a permanent improvement or betterment of property shall not be deductible as an expenditure for medical care, even though it may have some relation to medical care. Thus, the cost of a swimming pool, the addition of an elevator or a first floor bedroom and bath to a house for the benefit of a person unable to climb stairs, the installation of an oil burner to alleviate an allergy to coal, etc., would not be a deductible expense. A capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, shall, however, be deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator

or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc.

(iv) Expenses paid for transportation primarily for and essential to the rendition of the medical care are expenses paid for medical care. However, an amount allowable as a deduction for "transportation primarily for and essential to medical care" shall not include the cost of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a taxpayer go to a warm climate in order to alleviate a specific chronic ailment, the cost of meals and lodging while there would not be deductible. On the other hand, if the travel is undertaken merely for the general improvement of a taxpayer's health, neither the cost of transportation nor the cost of meals and lodging would be deductible. If a doctor prescribes an operation or other medical care, and the taxpayer chooses for purely personal considerations to travel to another locality (such as a resort area) for the operation or the other medical care, neither the cost of transportation nor the cost of meals and lodging (except where paid as part of a hospital bill) is deductible.

(v) The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined in this subdivision shall be considered an institution for purposes of the rules provided herein. In general, the following rules will be applied:

(a) Where an individual is in an institution because his condition is such that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care. For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally

retarded or physically handicapped individual at an institution is within the meaning of the term "medical care".

(b) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for purposes of this section. For example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

(c) It is immaterial for purposes of this subdivision whether the medical care is furnished in a Federal or State institution or in a private institution.

(vi) See section 262 and the regulations thereunder for disallowance of deduction for personal, living, and family expenses not falling within the definition of medical care.

(2) *Medicine and drugs*.—The term "medicine and drugs" shall include only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs (whether or not requiring a prescription). Such term shall not include toiletries or similar preparations (such as toothpaste, shaving lotion, shaving cream, etc.) nor shall it include cosmetics (such as face creams, deodorants, hand lotions, etc., or any similar preparation used for ordinary cosmetic purposes) or sundry items. Amounts expended for items which, under this subparagraph, are excluded from the term "medicine and drugs" shall not constitute amounts expended for "medical care".

(3) *Status as spouse or dependent*.—In the case of medical expenses for the care of a person who is the taxpayer's spouse or dependent, the deduction under section 213 is allowable if the status of such person as "spouse" or "dependent" of the taxpayer exists either at the time the medical services were rendered or at the time the expenses were paid. In determining whether such status as "spouse" exists, a taxpayer who is legally separated from his spouse under a decree of separate maintenance is not considered as married. Thus, payments made in June 1956 by A, for medical services rendered in 1955 to B, his wife, may be deducted by A for 1956 even though, before the payments were made, B may have died or in 1956 secured a divorce. Payments made in July 1956 by C, for medical services rendered to D in 1955 may be deducted by C for 1956 even though C and D were not married until June 1956.

(f) *Exclusion of amount allowed for care of certain dependents*.—Amounts allowable under section 214 as a deduction for the care of certain dependents shall not be treated as expenses paid for medical care.

(g) *Reimbursement for expenses paid in prior years*.—(1) Where

reimbursement, from insurance or otherwise, for medical expenses is received in a taxable year subsequent to a year in which a deduction was claimed on account of such expenses, the reimbursement must be included in gross income in such subsequent year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year. See section 104, relating to compensation for injuries or sickness, and section 105(b), relating to amounts expended for medical care, and the regulations thereunder, with regard to amounts in excess of or not attributable to deductions allowed.

(2) If no medical expense deduction was taken in an earlier year, for example, if the standard deduction under section 141 was taken for the earlier year, the reimbursement received in the taxable year for the medical expense of the earlier year is not includible in gross income.

(3) In order to allow the same aggregate medical expense deductions as if the reimbursement received in a subsequent year or years had been received in the year in which the payments for medical care were made, the following rules shall be followed:

(i) If the amount of the reimbursement is equal to or less than the amount which was deducted in a prior year, the entire amount of the reimbursement shall be considered attributable to the deduction taken in such prior year (and hence includible in gross income); or

(ii) If the amount of the reimbursement received in such subsequent year or years is greater than the amount which was deducted for the prior year, that portion of the reimbursement received which is equal in amount to the deduction taken in the prior year shall be considered as attributable to such deduction (and hence includible in gross income); but

(iii) If the deduction for the prior year would have been greater but for the limitations on the maximum amount of such deduction provided by section 213(c), then the amount of the reimbursement attributable to such deduction (and hence includible in gross income) shall be the amount of the reimbursement received in a subsequent year or years reduced by the amount disallowed as a deduction because of the maximum limitation, but not in excess of the deduction allowed for the previous year.

(4) The application of subparagraphs (1), (2), and (3) of this paragraph may be illustrated by the following examples:

*Example (1).* Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of \$35,000 for the calendar year 1956. During 1956 he paid \$9,000 for medical care. A received no reimbursement for such medical expenses in 1956, but in 1957 he received \$6,000 upon an insurance policy covering the medical expenses which he paid in 1956. A was allowed a deduction of \$5,000 (the maximum) from his adjusted gross income for 1956. The amount which A must include in his gross income for 1957 is \$3,050 and the amount to be excluded from gross income for 1957 is \$2,950, computed as follows:

Payments for medical care in 1956 (not reimbursed in 1956).....	\$9,000
Less: 3 percent of \$35,000 (adjusted gross income).....	1,050
Excess of medical expenses not reimbursed in 1956 over 3 percent of adjusted gross income .....	7,950
Allowable deduction for 1956.....	5,000
Amount by which the medical deduction for 1956 would have been greater than \$5,000 but for the limitations on the maximum amount provided by section 213 .....	2,950
Reimbursement received in 1957.....	\$6,000
Less: Amount by which the medical deduction for 1956 would have been greater than \$5,000 but for the limitations on the maximum amount provided by section 213.....	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than \$5,000 but for the limitations on the maximum amount provided by section 213 .....	3,050
Amount attributed to medical deduction taken for 1956.....	\$3,050
Amount to be included in gross income for 1957.....	3,050
Amount to be excluded from gross income for 1957 (\$6,000 less \$3,050) ..	2,950

*Example (2).* Assuming that A, in example (1), received \$8,000 in 1957 as reimbursement for the medical expenses which he paid in 1956, the amount which A must include in his gross income for 1957 is \$5,000 and the amount to be excluded from gross income for 1957 is \$3,000, computed as follows:

Reimbursement received in 1957.....	\$8,000
Less: Amount by which the medical deduction for 1956 would have been greater than \$5,000 but for the limitations on the maximum amount provided by section 213 .....	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than \$5,000 but for the limitations on the maximum amount provided by section 213..	\$5,050
Deduction allowable for 1956.....	\$5,000
Amount of reimbursement received in 1957 to be included in gross income for 1957 as attributable to deduction allowable for 1956.....	5,000
Amount to be excluded from gross income for 1957 (\$8,000 less \$5,000) ..	3,000

(h) *Substantiation of deductions.*—In connection with claims for deductions under section 213, the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and date of the payment thereof in each case. If payment was made in kind, such fact shall be so reflected. Claims for deductions must be substantiated, when requested by the district director, by a statement or itemized invoice from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid therefor and the date of the payment thereof; and by such other information as the district director may deem necessary.

## § 1.215 STATUTORY PROVISIONS; ALIMONY, ETC., PAYMENTS.

### SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) *GENERAL RULE.*—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71

in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71(d) or 682, the amount thereof is not includible in the husband's gross income.

(b) CROSS REFERENCE.—For definitions of "husband" and "wife", see section 7701(a) (17).

§ 1.215-1 PERIODIC ALIMONY, ETC., PAYMENTS.—(a) A deduction is allowable under section 215 with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 71. As to the amounts required to be included in the income of such wife or former wife, see section 71 and the regulations thereunder. For definition of "husband" and "wife", see section 7701(a) (17).

(b) The deduction under section 215 is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 71 in the income of the wife or former wife, which payment is attributable to property transferred in discharge of his obligation and which, under section 71(d) or section 682, is not includible in his gross income.

(c) The following examples, in which both H and W file their income tax returns on the basis of a calendar year, illustrate cases in which a deduction is or is not allowed under section 215:

*Example (1).* Pursant to the terms of a decree of divorce, H in 1956, transferred securities valued at \$100,000 in trust for the benefit of W, which fully discharged all his obligations to W. The periodic payments made by the trust to W are required to be included in W's income under section 71. Such payments are stated in section 71(d) not to be includible in H's income and, therefore, under section 215 are not deductible from his income.

*Example (2).* A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W \$5,000 a year for the remainder of her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1956 the trustee paid to W \$4,000 from the income of the trust and \$1,000 from the corpus of the trust. Under the provisions of sections 71 and 682(b), W would include \$5,000 in her income for 1956. H would not include any part of the \$5,000 in his income nor take a deduction therefor. If H had paid the \$1,000 to W pursuant to court order rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction of \$1,000 under the provisions of section 215.

(d) For other examples, see sections 71 and 682, and the regulations thereunder.

§ 1.216 STATUTORY PROVISIONS; AMOUNTS REPRESENTING TAXES AND INTEREST PAID TO COOPERATIVE HOUSING CORPORATION.

SEC. 216. AMOUNTS REPRESENTING TAXES AND INTEREST PAID TO COOPERATIVE HOUSING CORPORATION.

(a) ALLOWANCE OF DEDUCTION.—In the case of a tenant-stockholder (as defined in subsection (b) (2), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—

(1) the real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated, or

(2) the interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation on its indebtedness contracted—

(A) in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) in the acquisition of the land on which the houses (or apartment building) are situated.

(b) DEFINITIONS.—For purposes of this section—

(1) COOPERATIVE HOUSING CORPORATION.—The term “cooperative housing corporation” means a corporation—

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholders of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) TENANT-STOCKHOLDER.—The term “tenant-stockholder” means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to house or apartment which such individual is entitled to occupy.

(3) The term “tenant-stockholder's proportionate share” means that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation (including any stock held by the corporation).

§ 1.216-1 AMOUNTS REPRESENTING TAXES AND INTEREST PAID TO COOPERATIVE HOUSING CORPORATION.—(a) *General rule.*—A tenant-stockholder may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative housing corporation representing certain taxes or interest paid or incurred by the corporation. Such amounts are not allowable as a deduction unless they represent the tenant-stockholder's proportionate share of—

(1) The real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on the houses (or apartment building) and the land on which the houses (or apartment building) are situated, or



(2) The interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses (or apartment building), or in the acquisition of the land on which the houses (or apartment building) are situated.

(b) *Limitation*.—The deduction allowable under section 216 shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. In case a tenant-stockholder pays or incurs all or a part of his proportionate share of such taxes and interests to the corporation, the amount so paid or incurred which represents taxes and interest is allowable as a deduction if the requirements of section 216 are otherwise satisfied. As used in this section, the tenant-stockholder's proportionate share is that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. If a tenant-stockholder pays or incurs to the corporation an amount on account of such taxes and interest and other items, such as maintenance, overhead expenses, and curtailment of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 216 for such part of amounts representing the taxes or interest described in that section as is deductible by a tenant-stockholder under any other provision of the Internal Revenue Code of 1954.

(c) *Cooperative housing corporation*.—(1) *One class of stock*.—In order to qualify as a "cooperative housing corporation" under section 216, the corporation shall have one and only one class of stock outstanding. However, a special classification of preferred stock, in a nominal amount not exceeding \$100, issued to a Federal housing agency or other governmental agency solely for the purpose of creating a security device on the mortgage indebtedness of the corporation, will not be considered as a "class of stock" within the meaning of section 216.

(2) *Right of occupancy*.—Each stockholder of the corporation must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reason of his ownership of stock in the corporation, that is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial.

(3) *Distributions*.—None of the stockholders of the corporation may be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings or profits of the corporation.

(4) *Gross income*.—It is a prerequisite to the allowance of a deduction under section 216 that at least 80 percent of the gross income of the corporation for the taxable year of the corporation in which the taxes and interest are paid or incurred is derived from tenant-stockholders.

(d) *Tenant-stockholder*.—The term “tenant-stockholder” means an individual who is a stockholder in a cooperative housing corporation, as defined in section 216, and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the district director as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation’s equity in the building and the land on which it is situated which is attributable to the apartment or housing unit which such individual is entitled to occupy.

(e) *Examples*.—The application of section 216 may be illustrated by the following examples, which refer to apartments but which are equally applicable to housing units:

*Example (1)*. The X Corporation is, and at all times since 1957 has been, a cooperative housing corporation within the meaning of section 216. In 1957 it purchased a site and constructed thereon a building with 10 apartments at a total cost of \$200,000. The fair market value of the land and building was likewise \$200,000 at the time of completion of the building. Each apartment is of equal value. Upon completion of the building, the X Corporation mortgaged the land and building for \$100,000, and sold its total authorized capital stock, consisting of 1,000 shares of common stock, for \$100,000. The stock was purchased by 10 individuals, each of whom paid \$10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified term of years. Each lease provides that the lessee shall pay his proportionate part of the corporation’s expenses. In 1957 the original owner of 100 shares of the common stock of the X Corporation and of the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its taxable income on an accrual method, while A computes his taxable income on the cash receipts and disbursements method. In 1958 the X Corporation incurred expenses aggregating \$13,800, namely, \$4,000 for the real estate taxes on the land and building, \$5,000 for the interest on the mortgage, \$3,000 for the maintenance of the building, and \$1,800 for other expenses. In 1959, A pays the X Corporation \$1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1958 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of \$900 in computing his taxable income for 1959. The deduction is computed as follows:

Shares of stock of X Corporation owned by A.....	100
Shares of stock of X Corporation owned by 9 other tenant-stockholders.....	900
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Total shares of stock of X Corporation outstanding.....	1,000
Proportion of outstanding stock of X Corporation owned by A.....	1/10
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Expenses incurred by X Corporation:	
Real estate taxes .....	\$4,000
Interest .....	5,000
Maintenance .....	3,000
Other expenses .....	1,800
<hr/>	

\$13,800

Amount paid by A representing his proportionate part of such expenses (1/10 of \$13,800) ..... \$1,380

A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of \$9,000) .....	\$900
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of \$13,800) .....	1,380
Amount of A's payment representing real estate taxes and interest (900/1380 of \$1,380) .....	900
A's allowable deduction .....	900

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the land and building which is attributable to apartment No. 1, the requirement of section 216 in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

*Example (2).* The facts are the same as in example (1) except that the building constructed by the X Corporation contained, in addition to the 10 apartments, business space on the ground floor, which the corporation rented at \$2,400 for the calendar year 1958. The corporation deducted the \$2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders. The amount paid by A to the corporation in 1959 is \$1,140 instead of \$1,380. More than 80 percent of the gross income of the corporation for 1958 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of \$743.48 in computing his taxable income for 1959. The deduction is computed as follows:

Expenses incurred by X Corporation.....	\$13,800.00
Less: Rent from business space.....	2,400.00
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Expenses to be prorated among tenant-stockholders.....	\$11,400.00
Amount paid by A representing his proportionate part of such expenses (1/10 of \$11,400) .....	1,140.00
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A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of \$9,000) .....	\$900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of \$13,800) .....	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of \$1,140) .....	743.48
A's allowable deduction .....	743.48

Since the portion of A's payment allocable to real estate taxes and interest is only \$743.48, that amount instead of \$900 is allowable as a deduction in computing A's taxable income for 1959.

*Example (3).* The facts are the same as in example (2) except that the amount paid by A to the X Corporation in 1959 is \$1,000 instead of \$1,140. A is entitled under section 216 to a deduction of \$652.17 in computing his taxable income for 1959. The deduction is computed as follows:

Total amount paid by A.....	\$1,000.00
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of \$9,000).....	900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of \$13,800).....	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of \$1,000) .....	652.17
A's allowable deduction .....	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only \$652.17, that amount instead of \$900 is allowable as a deduction in computing A's taxable income for 1959.

## § 1.217 STATUTORY PROVISIONS; CROSS REFERENCES.

### SEC. 217. CROSS REFERENCES.

(1) For deduction for long-term capital gains in the case of a taxpayer other than a corporation, see section 1202.

(2) For deductions in respect of a decedent, see section 691.

### ITEMS NOT DEDUCTIBLE

## § 1.264 STATUTORY PROVISIONS; ITEMS NOT DEDUCTIBLE; CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

### SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) **GENERAL RULE.**—No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

(b) **CONTRACTS TREATED AS SINGLE PREMIUM CONTRACTS.**—For purposes of subsection (a) (2), a contract shall be treated as a single premium contract—

(1) if substantially all the premium on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264-1 **PREMIUMS ON LIFE INSURANCE TAKEN OUT IN A TRADE OR BUSINESS.**—(a) *When premiums are not deductible.*—Premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer's gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially

interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy. For additional provisions relating to the nondeductibility of premiums paid on life insurance policies (whether under section 162 or any other section of the Internal Revenue Code of 1954), see section 262, relating to personal, living, and family expenses, and section 265, relating to expenses allocable to tax-exempt income.

(b) *When taxpayer is a beneficiary.*—If a taxpayer takes out a policy for the purpose of protecting himself from loss in the event of the death of the insured, the taxpayer is considered a beneficiary directly or indirectly under the policy. However, if the taxpayer is not a beneficiary under the policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. See section 162 and the regulations thereunder. A taxpayer is considered a beneficiary under a policy where, for example, he, as a principal member of a partnership, takes out an insurance policy on his own life irrevocably designating his partner as the sole beneficiary in order to induce his partner to retain his investment in the partnership. Whether or not the taxpayer is a beneficiary under a policy, the proceeds of the policy paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of (1) certain transferees, as provided in section 101(a)(2); (2) portions of amounts of life insurance proceeds received at a date later than death under the provisions of section 101(d); and (3) life insurance policy proceeds which are includible in the gross income of a husband or wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.). (See section 101(e).) For further reference, see, generally, section 101 and the regulations thereunder.

§ 1.264-2 SINGLE PREMIUM LIFE INSURANCE, ENDOWMENT, OR ANNUITY CONTRACTS.—Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance or endowment contract, or to purchase or to continue in effect a single premium annuity contract purchased (whether from the insurer, annuitant, or any other person) after March 1, 1954, are not deductible under section 163 or any other provision of chapter 1 of the Internal Revenue Code of 1954. This prohibition applies even though the insurance is not on the life of the taxpayer and regardless of whether or not the taxpayer is the annuitant or payee of such annuity contract. A contract is considered a single premium life insurance, endowment, or annuity contract, for the purposes of this section, if substantially all the premiums on the contract are paid within four years from the date on which the contract was purchased, or if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264-3 EFFECTIVE DATE; TAXABLE YEARS ENDING AFTER MARCH 1, 1954, SUBJECT TO THE INTERNAL REVENUE CODE OF 1939.—Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.264-2, to

§ 1.264-1(b)

the extent that they relate to amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract, shall also apply to taxable years beginning before January 1, 1954, and ending after March 1, 1954, and to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939.

## § 1.268 STATUTORY PROVISIONS; SALE OF LAND WITH UNHARVESTED CROP.

### SEC. 268. SALE OF LAND WITH UNHARVESTED CROP.

Where an unharvested crop sold by the taxpayer is considered under the provisions of section 1231 as "property used in the trade or business", in computing taxable income no deduction (whether or not for the taxable year of the sale and whether for expenses, depreciation, or otherwise) attributable to the production of such crop shall be allowed.

§ 1.268-1 ITEMS ATTRIBUTABLE TO AN UNHARVESTED CROP SOLD WITH THE LAND.—In computing taxable income no deduction shall be allowed in respect of items attributable to the production of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231(b)(4). Such items shall be so treated whether or not the taxable year involved is that of the sale, exchange, or conversion of such crop and whether they are for expenses, depreciation, or otherwise. If the taxable year involved is not that of the sale, exchange, or conversion of such crop, a recomputation of the tax liability for such year shall be made; such recomputation should be in the form of an "amended return" if necessary. For the adjustments to basis as a result of such disallowance, see section 1016(a)(11) and the regulations thereunder.

## § 1.270 STATUTORY PROVISIONS; LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES.

### SEC. 270. LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES.

(a) RECOMPUTATION OF TAXABLE INCOME.—If the deductions allowed by this chapter or the corresponding provisions of prior revenue laws (other than specially treated deductions, as defined in subsection (b)) allowable to an individual (except for the provisions of this section or the corresponding provisions of prior revenue laws) and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years (including at least one year to which this subtitle applies), exceeded by more than \$50,000 the gross income derived from such trade or business, the taxable income (computed under section 63 or the corresponding provisions of prior revenue laws) of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of \$50,000 plus the gross income attributable to such trade or business, except that the net operating loss deductions, to the extent attributable to such trade or business, shall not be allowed.

(b) **SPECIALLY TREATED DEDUCTIONS.**—For the purpose of subsection (a) the specially treated deductions shall be taxes, interest, casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1), losses and expenses of the trade or business of farming which are directly attributable to drought, the net operating loss deduction allowed by section 172, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses when incurred or (2) to defer or capitalize.

(c) **REDETERMINATION OF TAX.**—On the basis of the taxable income computed under the provisions of subsection (a) for each of the 5 consecutive taxable years specified in such subsection, the tax imposed by this subtitle or the corresponding provisions of prior revenue laws shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of section 1311 and following) by the operation of any law or rule of law (other than section 7122, relating to compromises), any increase in the tax previously determined for such taxable year shall be considered a deficiency for purposes of this section. For purposes of this section, the term "tax previously determined" shall have the meaning assigned to such term by section 1314(a)(1).

(d) **EXTENSION OF STATUTE OF LIMITATIONS.**—Notwithstanding any law or rule of law (other than section 7122, relating to compromises), any amount determined as a deficiency under subsection (c), or which would be so determined if assessment were prevented in the manner described in subsection (c), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the 5 consecutive taxable years specified in subsection (a), 1 year remained before the expiration of the period of limitation upon assessment for any such taxable year.

**§ 1.270-1 LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES.**—(a) *Recomputation of taxable income.*—(1) Under certain circumstances, section 270 limits the deductions (other than certain deductions described in subsection (b) thereof) attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1 of the Internal Revenue Code of 1954 or the corresponding provisions of prior revenue laws. If, in each of five consecutive taxable years (including at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954), the deductions attributable to a trade or business carried on by an individual (other than the specially treated deductions described in paragraph (b) of this section) exceed the gross income derived from such trade or business by more than \$50,000, the taxable income computed under section 63 (or the net income computed under the corresponding provisions of prior revenue laws) of such individual shall be recomputed for each of such taxable years.

(2) In recomputing the taxable income (or the net income, in the case of taxable years which are otherwise subject to the Internal Revenue Code of 1939) for each of the five taxable years, the deductions (other than the specially treated deductions described in paragraph (b) of this section with the exception of the net operating loss deduction) attributable to the trade or business carried on by the individual shall be allowed only to the extent of (i) the gross income derived from such trade or business, plus (ii) \$50,000. The specially treated deductions described in paragraph (b) of this section (other than the net operating loss deduction) shall each be allowed in full. The net operating loss deduction, to the extent attributable to such trade or

business, shall be disallowed in its entirety. Thus, a carryover or a carryback of a net operating loss so attributable, either from a year within the period of five consecutive taxable years or from a taxable year outside of such period, shall be ignored in making the recomputation of taxable income or net income, as the case may be.

(3) The limitations on deductions provided by section 270 are also applicable in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover or carryback from any year which falls within the provisions of section 270 to any year which does not fall within such provisions. Also, in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover from a year which falls within the provisions of section 270 to a year which does not fall within such provisions, the amount of net operating loss is to be reduced by the taxable income or net income, as the case may be (computed as provided in § 1.172-5, or § 39.122-4(c) of Regulations 118, as the case may be and, in the case of any taxable year which falls within the provisions of section 270, determined after the application of section 270), of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 172(b), or the corresponding provisions of prior revenue laws, even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(4) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses and the gross income derived therefrom shall not be aggregated in determining whether the deductions (other than the specially treated deductions) exceed the gross income derived from such trades or businesses by more than \$50,000 in any taxable year. For the purposes of section 270, each trade or business shall be considered separately. However, where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual's share of the profits and losses from each business unit must be aggregated to determine the applicability of section 270. See § 1.702-1(a)(8)(ii) and (b), relating to applicability of section 270 to a partner. Where it is established that for tax purposes a husband and wife are partners in the same trade or business or that each is participating independently of the other in the same trade or business with his and her own money, the husband's gross income and deductions from that trade or business shall be considered separately from the wife's gross income and deductions from that trade or business even though they file a joint return. Where a taxpayer is engaged in a trade or business in a community property State under circumstances such that the income therefrom is considered to be community income, the taxpayer and his spouse are treated for purposes of section 270 as two individuals engaged separately in the same trade or business and the gross income and deductions attributable to the trade or business are allocated one-half to the taxpayer and one-half to the spouse. Where several business activities emanate



from a single commodity, such as oil or gas or a tract of land, it does not necessarily follow that such activities are one business for the purposes of section 270. However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other. For the purposes of section 270, the trade or business carried on by an individual must be the same in each of the five consecutive years in which the deductions (other than the specially treated deductions) exceed the gross income derived from such trade or business by more than \$50,000.

(5) For the purposes of section 270, a taxable year may be part of two or more periods of five consecutive taxable years. Thus, if the deductions (other than the specially treated deductions) attributable to a trade or business carried on by an individual exceed the gross income therefrom by more than \$50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a 5-year period beginning with the first and ending with the fifth taxable year and of a 5-year period beginning with the second and ending with the sixth taxable year.

(6) For the purposes of section 270, a short taxable year required to effect a change in accounting period constitutes a taxable year. In determining the applicability of section 270 in the case of a short taxable year, items of income and deduction are not annualized.

(b) *Specially treated deductions.*—(1) For the purposes of section 270 and paragraph (a) of this section, the specially treated deductions are:

- (i) Taxes,
- (ii) Interest,
- (iii) Casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1), or the corresponding provisions of prior revenue laws,
- (iv) Losses and expenses of the trade or business of farming which are directly attributable to drought,
- (v) The net operating loss deduction allowed by section 172, or the corresponding provisions of prior revenue laws, and
- (vi) Expenditures as to which a taxpayer is given the option, under law or regulations, either (a) to deduct as expenses when incurred, or (b) to defer or capitalize.

(2) For the purpose of subparagraph (1)(iv) of this paragraph, an individual is engaged in the "trade or business of farming" if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. An individual who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming. However, an individual who receives a fixed-rental (without reference to production) is engaged in the trade or business of farming only if he participates to a material extent in the operation or management of the farm. An individual engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming. An individual cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the trade or business of farming. The term "farm" is

used in its ordinarily accepted sense and includes stock, dairy, poultry, fruit, crop, and truck farms, and also plantations, ranches, ranges, and orchards. An individual is engaged in the trade or business of farming if he is a member of a partnership engaged in the trade or business of farming.

(3) In order for losses and expenses of the trade or business of farming to qualify as specially treated deductions under subparagraph (1) (iv) of this paragraph, such losses and expenses must be directly attributable to drought conditions and not to other causes such as faulty management or unfavorable market conditions. In general, the following are the types of losses and expenses which, if otherwise deductible, may qualify as specially treated deductions under subparagraph (1) (iv) of this paragraph:

(i) Losses for damages to or destruction of property as a result of drought conditions, if such property is used in the trade or business of farming or is purchased for resale in the trade or business of farming;

(ii) Expenses directly related to raising crops or livestock which are destroyed or damaged by drought. Included in this category are, for example, payments for labor, fertilizer, and feed used in raising such crops or livestock. If such crops or livestock to which the expenditures relate are only partially destroyed or damaged by drought then only a proportionate part of the expenditures is regarded as specially treated deductions; and

(iii) Expenses which would not have incurred in the absence of drought conditions, such as expenses for procuring pasture or additional supplies of water or feed.

(4) The expenditures referred to in subparagraph (1) (vi) of this paragraph include, but are not limited to, intangible drilling and development costs in the case of oil and gas wells as provided in section 263(c) and the regulations thereunder, and expenditures for the development of a mine or other natural deposit (other than an oil or gas well) as provided in section 616 and the regulations thereunder.

(5) The provisions of section 270(b) do not operate to make an expenditure a deductible item if it is not otherwise deductible under the law applicable to the particular year in which it was incurred. Thus, for example, if it is necessary, pursuant to the provisions of section 270, to recompute the taxable or net income of an individual for the taxable years 1950 through 1954, the individual in making the recomputation may not deduct expenditures paid or incurred in the years 1950 through 1953 which must be capitalized under the law applicable to those years, even though the expenditures are deductible under the Internal Revenue Code of 1954.

(c) *Applicability to taxable years otherwise subject to the Internal Revenue Code of 1939.*—The net income of a taxable year otherwise subject to the Internal Revenue Code of 1939 shall be recomputed pursuant to section 270 if (i) such taxable year is included in a period of five consecutive taxable years which includes at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954, and (ii) the deductions (other than the specially treated deduc-

tion specified in section 270(b)) for each taxable year in such 5-year period exceed the \$50,000 limitation specified in section 270. As described in paragraph (a) (5) of this section, a taxable year may be part of two or more periods of five consecutive taxable years. If a particular taxable year is part of two periods of five consecutive taxable years, one meeting the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939 and the other meeting the requirements for recomputation pursuant to section 270 of the Internal Revenue Code of 1954, then the recomputation for such taxable year shall be made pursuant to section 270. For example, if a calendar year taxpayer sustains a loss from a trade or business for each of the years 1949 through 1954, the years 1950, 1951, 1952, and 1953 may be a part of two such periods of five consecutive taxable years. If, however, a taxable year is part of a period of five consecutive taxable years which meets the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939, but is not part of a period which meets the requirements for recomputation pursuant to section 270, then a recomputation of net income for such taxable year must be made pursuant to section 130.

(d) *Redetermination of tax.*—The tax imposed by chapter 1 of the Internal Revenue Code of 1954, or by the corresponding provisions of prior revenue laws, for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the taxable income or net income of the individual, as the case may be, recomputed in the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of sections 1311 through 1315, inclusive, relating to the effect of limitations and other provisions in income tax cases) by the operation of any provision of law (e.g., sections 6501 and 6502, or the corresponding provisions of prior revenue laws, relating to the period of limitations upon assessment and collection) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by any rule of law (e.g., *res judicata*), then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for the purposes of section 270. The term “tax previously determined” shall have the same meaning as that assigned to such term by section 1314(a). See § 1.1314(a)–1.

(e) *Assessment of tax.*—Any amount determined as a deficiency in the manner described in paragraph (d) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 270, the amount of the actual deficiency as defined in section 6211(a) (whether it is greater than, equal to, or less than the deficiency determined under section 270(c)) shall be assessed and collected. However, if the assess-

ment of a deficiency for such taxable year would be prevented by any provision of law (e.g., the period of limitation upon the assessment of tax) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by the operation of any rule of law (e.g., *res judicata*), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 6211(a), in respect of the given taxable year.

## § 1.271 STATUTORY PROVISIONS; DEBTS OWED BY POLITICAL PARTIES, ETC.

### SEC. 271. DEBTS OWED BY POLITICAL PARTIES, ETC.

(a) **GENERAL RULE.**—In the case of a taxpayer (other than a bank as defined in section 581) no deduction shall be allowed under section 166 (relating to bad debts) or under section 165(g) (relating to worthlessness of securities) by reason of the worthlessness of any debt owed by a political party.

(b) **DEFINITIONS.**—

(1) **POLITICAL PARTY.**—For purposes of subsection (a), the term “political party” means—

(A) a political party;

(B) a national, State, or local committee of a political party; or

(C) a committee, association, or organization which accepts contributions or makes expenditures for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors or of any individual whose name is presented for election to any Federal, State, or local elective public office, whether or not such individual is elected.

(2) **CONTRIBUTIONS.**—For purposes of paragraph (1)(C), the term “contributions” includes a gift, subscription, loan, advance, or deposit, of money, or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) **EXPENDITURES.**—For purposes of paragraph (1)(C), the term “expenditures” includes a payment, distribution, loan, advance, deposit, or gift, of money, or anything of value, and includes a contract, promise, or agreement to make an expenditure, whether or not legally enforceable.

## § 1.272 STATUTORY PROVISIONS; DISPOSAL OF COAL.

### SEC. 272. DISPOSAL OF COAL.

Where the disposal of coal is covered by section 631, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that if in any taxable year such expenditures plus the adjusted depletion basis of the coal disposed of in such taxable year exceed the amount realized under such contract, such excess, to the extent not availed of as a reduction of gain under section 1231, shall be a loss deductible under section 165(a). This section shall not apply to any taxable year during which there is no income under the contract.

§ 1.272-1 **EXPENDITURES RELATING TO DISPOSAL OF COAL.**—(a) *Introduction.*—Section 272 provides special treatment for certain expenditures paid or incurred by a taxpayer in connection with a contract (hereafter sometimes referred to as a “coal royalty contract”) for the disposal of coal the gain or loss from which is treated under section 631(c) as a section 1231 gain or loss on the sale of coal. The expenditures covered by section 272 are those which are attributable

to the making and administering of such a contract or to the preservation of the economic interest retained under the contract. For examples of such expenditures, see paragraph (d) of this section. For a taxable year in which gross royalty income is realized under the contract of disposal, such expenditures shall not be allowed as a deduction. Instead, they are to be added to the adjusted depletion basis of the coal disposed of in such taxable year in computing gain or loss under section 631(c). However, where no gross royalty income is realized under the contract of disposal in a particular taxable year, such expenditures shall be treated without regard to section 272.

(b) *In general.*—(1) Where the disposal of coal is covered by section 631(c), the provisions of section 272 and this section shall be applicable for a taxable year in which there is income under the contract of disposal. (For purposes of section 272 and this section, the term “income” means gross amounts received or accrued which are royalties or bonuses in connection with a contract to which section 631(c) applies.) All expenditures paid or incurred by the taxpayer during such taxable year which are attributable to the making and administering of the contract disposing of the coal and all expenditures paid or incurred during such taxable year in order to preserve the owner’s economic interest retained under the contract shall be disallowed as deductions in computing taxable income for such taxable year. The sum of such expenditures and the adjusted depletion basis of the coal disposed of in such taxable year shall be used in determining the amount of gain or loss with respect to the disposal. See § 1.631–3. For special rule in case of loss, see paragraph (c) of this section. Section 272 and this section are not applicable to capital expenditures and such expenditures are not taken into account in computing gain or loss under section 631(c) except to the extent they are properly part of the depletable basis of such coal.

(2) The expenditures covered under section 272 and this section are disallowed as a deduction only with respect to a taxable year in which income is realized under the coal royalty contract to which such expenditures are attributable. Where no income is realized under such contract in a taxable year, these expenditures shall be deducted as expenses for the production of income, as a business expense, or may be treated under section 266 (relating to taxes and carrying charges) if applicable.

(3) The provisions of section 272 and this section apply to a taxable year in which income from the disposal by the owner of coal held by him for more than six months is subject to the provisions of section 631(c) even though the actual mining of coal under the coal royalty contract does not take place during such year. Where the right under the contract to mine coal for which advance payment has been made expires, terminates, or is abandoned before such coal is mined, and § 1.631–3(c) requires the owner to recompute his tax with respect to such payment the recomputation must be made without applying the provisions of section 272 and this section.

(c) *Losses.*—If, in any taxable year, the expenditures referred to in section 272 and this section plus the adjusted depletion basis (as defined in paragraph (b) (2) of § 1.631–3) of the coal disposed of during the taxable year exceed the amount realized under the con-

tract which is subject to section 631(c) during the taxable year, such excess shall be considered under section 1231 as a loss from the sale of property used in the trade or business and, to the extent not availed of as a reduction of gain under that section, shall be a loss deductible under section 165(a) (relating to the deduction of losses generally).

(d) *Examples of expenditures.*—(1) The expenditures referred to in section 272 include, but are not limited to, the following items, if such items are attributable to the making or administering of the contract or preserving the economic interest therein: Ad valorem taxes imposed by State or local authorities, costs of fire protection, costs of insurance (other than liability insurance), costs incurred in administering the contract (including costs of bookkeeping and technical supervision), interest on loans, expenses of flood control, legal and technical expenses, and expenses of measuring and checking quantities of coal disposed of under the contract. Whether the interest on loans is attributable to the making or administering of the contract or preserving the economic interest therein will depend upon the use to which the borrowed monies are put.

(2) Any expenditures referred to in this section which is applicable to more than one coal royalty contract shall be reasonably apportioned to each such contract. Furthermore, if an expenditure applies only in part to the making or administering of the contract or the preservation of the economic interest, then only such part shall be treated under section 272. The apportionment of the expenditure shall be made on a reasonable basis. For example, where a taxpayer has other income (such as income from oil or gas royalties, rentals, right of way fees, interest, or dividends) as well as income under section 631(c), and where the salaries of some of its employees or other expenses relate to both classes of income, such expenses shall be allocated reasonably between the income subject to section 631(c) and the other income. Where a taxpayer has more than one coal royalty contract, expenditures under this section relating to a contract from which no income has been received in the taxable year may not be allocated to income from another contract from which income has been received in the taxable year.

(3) The taxpayer may have expenses which are not attributable even partly to making and administering a coal royalty contract or to the preservation of the economic interest retained under the contract and, accordingly, are not included in the expenditures described in section 272. These include such items as ad valorem taxes imposed by State or local authorities on property not covered by the contract, salaries, wages, or other expenses entirely incident to the ownership and protection of such property and depreciation of improvements thereon, fire insurance on such property, charitable contributions, and similar expenses unrelated to the making or to the administering of coal royalty contracts or preserving the taxpayer's economic interest retained therein.

(e) *Nonapplication of section.*—For purposes of section 543(a)(8)(B), in determining whether the deductions allowable under section 162 constitute 15 percent or more of gross income, the provisions of section 272 shall have no application.

## DEFERRED COMPENSATION, ETC.

## MISCELLANEOUS PROVISIONS

## § 1.421 STATUTORY PROVISIONS; EMPLOYEE STOCK OPTIONS.

## SEC. 421. EMPLOYEE STOCK OPTIONS.

(a) TREATMENT OF RESTRICTED STOCK OPTIONS.—If a share of stock is transferred to an individual pursuant to his exercise after 1949 of a restricted stock option, and no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him—

(1) no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

This subsection and subsection (b) shall not apply unless (A) the individual, at the time he exercises the restricted stock option, is an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, or (B) the option is exercised by him within 3 months after the date he ceases to be an employee of such corporations.

(b) SPECIAL RULE WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 95 PERCENT OF VALUE OF STOCK.—If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subparagraph (d) (1) (A)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(1) in the case of a share of stock acquired under an option qualifying under clause (i) of subparagraph (d) (1) (A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(A) the fair market value of the share at the time of such disposition or death, or

(B) the fair market value of the share at the time the option was granted; or

(2) in the case of stock acquired under an option qualifying under clause (ii) of subparagraph (d) (1) (A), an amount equal to the lesser of—

(A) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(B) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(c) ACQUISITION OF NEW STOCK.—If stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036, or so much of section 1031 as relates to section 1036, applies and such distribution was

made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

(d) DEFINITIONS.—For purposes of this section—

(1) RESTRICTED STOCK OPTION.—The term “restricted stock option” means an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(A) at the time such option is granted—

(i) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(ii) in case the purchase price of the stock under the option is fixed or determinable under a formula in which the only variable is the value of the stock at any time during a period of 6 months which includes the time the option is exercised, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the value of the stock at the time such option is granted; and

(B) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(C) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This subparagraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after the date of enactment of this title. For purposes of this subparagraph—

(i) such individual shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(ii) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries; and

(D) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(2) PARENT CORPORATION.—The term “parent corporation” means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(3) SUBSIDIARY CORPORATION.—The term “subsidiary corporation” means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(4) DISPOSITION.—

(A) GENERAL RULE.—Except as provided in subparagraph (B), the term “disposition” includes a sale, exchange, gift, or a transfer of legal title, but does not include—

(i) a transfer from a decedent to an estate or a transfer by bequest or inheritance;



(ii) an exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

(iii) a mere pledge or hypothecation.

(B) JOINT TENANCY.—The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

(5) STOCKHOLDER APPROVAL.—If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(6) EXERCISE BY ESTATE.—

(A) IN GENERAL.—If a restricted stock option is exercised subsequent to the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of this section shall apply to the same extent as if the option had been exercised by the decedent, except that—

(i) the holding period and employment requirements of subsection (a) shall not apply, and

(ii) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of subsection (b).

(B) DEDUCTION FOR ESTATE TAX.—If an amount is required to be included under subsection (b) in gross income of the estate of the deceased employee or of a person described in subparagraph (A), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the restricted stock option. For this purpose, the deduction shall be determined under section 691 (c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under subsection (b) of this section were an amount included in gross income under section 691 in respect of such item of gross income.

(e) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

(1) RULES OF APPLICATION.—For purposes of subsection (d), if the terms of any option to purchase stock are modified, extended, or renewed, the following rules shall be applied with respect to transfers of stock made on the exercise of the option after the making of such modification, extension, or renewal—

(A) such modification, extension, or renewal shall be considered as the granting of a new option,

(B) the fair market value of such stock at the time of the granting of such option shall be considered as—

(i) the fair market value of such stock on the date of the original granting of the option,

(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal, whichever is the highest.

Subparagraph (B) shall not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(2) DEFINITION OF MODIFICATION.—The term “modification” means any change in the terms of the option which gives the employee addi-

tional benefits under the option, but such term shall not include a change in the terms of the option—

(A) attributable to the issuance or assumption of an option under subsection (g) ; or

(B) to permit the option to qualify under subsection (d) (1) (B). If an option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

(f) EFFECT OF DISQUALIFYING DISPOSITION.—If a share of stock, acquired by an individual pursuant to his exercise of a restricted stock option, is disposed of by him within 2 years from the date of the granting of the option or within 6 months after the transfer of such share to him, then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

(g) CORPORATE REORGANIZATIONS, LIQUIDATIONS, ETC.—For purposes of this section, the term “issuing or assuming a stock option in a transaction to which subsection (g) is applicable” means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

(1) the excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(2) the new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

#### § 1.421-1 MEANING AND USE OF CERTAIN TERMS.—(a) *Option*.—

(1) For the purpose of section 421, the term “option” includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time

of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at \$85 per share during 1955, or at \$75 per share during 1956, or at \$65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at \$85 per share during 1955, an alternative option for the purchase of 1,000 shares at \$75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at \$65 per share during 1957.

(b) *Time and date of granting of option.*—(1) For the purpose of section 421, the words “the date of the granting of the option” and “the time such option is granted”, and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421(d) (5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.*—For the purpose of section 421, the term “stock” means

capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price*.—(1) For the purpose of section 421, the term "option price" or "price paid under the option" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(i) The option price must be fixed or determinable at the time the option is granted; or

(ii) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option must provide that such price shall be determined by a formula in which the only variable is the value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Such formula may provide for determining such price by reference to such value on any particular day in such six-month period, or by reference to an average value of the stock over either the whole of such six-month period or over any shorter period included in such six-month period. Such six-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than \$85, nor more than \$110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than \$95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed \$100,000, the option price shall be \$15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed \$100,000, the option price shall be \$20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a) (1) of § 1.421-2.

An option which does not meet the requirements of either subdivision (i) or (ii) of this subparagraph when granted, will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see § 1.421-4(c)(2).

(e) *Exercise*.—For the purpose of section 421, the term "exercise", when used in reference to an option, means the act of acceptance by

the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer*.—For the purpose of section 421, the term “transfer”, when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

§ 1.421-2 RESTRICTED STOCK OPTION.—(a) *In general*.—(1) A “restricted stock option” is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in § 1.421-1(d) (2) (ii), the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1954, an option is granted providing that the option price shall be \$10 under the average value of the stock during the month preceding the month in which the option is exercised, and if on June 15, 1954, the value of the stock subject to the option is \$100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average value of the stock during the month of May 1954. If such average value is \$95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such indi-

§ 1.421-1(f)

vidual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder. An option granted before employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see § 1.421-1(b)(2). The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation.

(4) An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option. However, in case the option contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a restricted stock option.

(5) Any reasonable valuation methods may be used for the purpose of determining whether at the time the option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option. Such methods include the valuation methods described in § 20.2031-2 of this chapter (the Estate Tax Regulations).

(b) *Ownership of 10 percent of stock.* In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test of section 421(d)(1)(C), stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned

proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

§ 1.421-3 EXERCISE OF RESTRICTED STOCK OPTION.—(a) The special rules of income tax treatment provided in section 421 (a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421 (g) (see § 1.421-4(d)), or was an employee of any such corporations within three months before the date the option is exercised.

(b)(1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421(g). See § 1.421-4(d). In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

*Example (2).* Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421 (g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent

events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421-4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* S-1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S-1. On January 1, 1955, S sells a portion of the S-1 stock which it owns to an unrelated corporation and, as of that date, S-1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has exercised a restricted stock option.

*Example (2).* Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S-1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S-1 stock to make S-1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see § 1.421-5(d).

§ 1.421-4 MODIFICATION, EXTENSION, OR RENEWAL.—(a) *In general.*—Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.*—(1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d) (1) (A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.



(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for \$85. The fair market value of such stock on June 1, 1954, was \$100. On June 15, 1955, when the fair market value of the stock is \$60, such option is extended so that it is exercisable at any time before July 1, 1956, at \$55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954		1955	
June .....	\$100	January .....	\$90
July .....	90	February .....	80
August .....	80	March .....	70
September .....	70	April .....	60
October .....	80	May .....	60
November .....	80		
December .....	90		

The aggregate of such values is \$950. When this sum is divided by 12, the result is \$79.17, which is an amount less than 80 percent of the fair market value of the stock (\$100) when the option was granted. Accordingly, when the option is extended on June 15, 1955, the option price could have been reduced as low as \$51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to \$960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) *Definition of modification, extension, or renewal.*—(1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules

governing determination of the time or date of granting an option provided in § 1.421-1(b). For the purpose of section 421, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for \$80 a share of stock, the fair market value of which was \$100 at such time, and if later the option price is increased to \$85 in order to meet the requirement of section 421(d)(1)(A), such change is a modification of the option, although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than \$100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) *Assumption or substitution of restricted stock options in connection with certain corporate transactions.*—(1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term "corporate transaction" means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a "corporate transaction" includes a taxable transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2) (i) Section 421(g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421(g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume restricted stock options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421(g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421(g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421(g) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421(g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph).

However, a corporation which has issued an option may not substitute a new option for such option under section 421(g).

(3) For section 421(g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421(g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421(g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 421(g). For section 421(g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421(g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Thus, section 421(g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421(g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421(g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421(g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421(g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at \$42.50 a share, was granted when the stock had a fair market value of \$50 a share, and the stock was worth \$100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth \$50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at \$21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at \$21.25 a share in substitution for his right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before

the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031-2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 421 (g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) *Effect on qualification.*—A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) *Examples.*—The rule stated in section 421 (e) may be illustrated by the following examples:

*Example (1).* On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at \$90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be \$80 per share. On February 1, 1955, the fair market value of the X Corporation stock is \$90 per share. Under section 421 (e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b) (3) of this section applicable, such option shall be treated as an option to purchase at \$80 per share 100 shares of stock having a fair market value of \$100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

*Example (2).* On June 1, 1954, the X Corporation grants to an

employee a restricted stock option to purchase 100 shares of X Corporation stock at \$90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is \$100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock is \$110 per share. Under section 421(e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at \$90 per share 100 shares of stock having a fair market value of \$110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

*Example (3).* The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

*Example (4).* On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at \$80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at \$80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is \$90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

§ 1.421-5 OPERATION OF SECTION 421.—(a) *Rules applicable to all restricted stock options.*—(1) *In general.*—If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him, then, under section 421(a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employed corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or

issued the option under section 421(g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred. For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) *Holding period.*—The special rules provided in section 421(a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 6-month period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of this section.

(3) *Disposition of stock.*—(i) For the purpose of section 421, the term “disposition” includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(a) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(b) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(c) A mere pledge or hypothecation.

However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint

owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples.*—The rules of section 421(a) may be illustrated by the following examples:

*Example (1).* On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at \$95 per share. On that date, the fair market value of X Corporation stock is \$100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation \$9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of \$12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is \$9,500.

*Example (2).* Assume, in example (1), that on August 1, 1956, two years and one month after the granting of the option and one year and one month after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of \$3,500 (\$13,000 minus E's basis of \$9,500), which is treated as long-term capital gain.

*Example (3).* Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of \$9,500 becomes the donee's basis for determining gain or loss.

*Example (4).* Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

*Example (5).* Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is \$12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is \$12,500.

(b) *Additional rules applicable where the option price is between*



85 percent and 95 percent of the value of the stock.—(1) *In general.*—

(i) If all the conditions necessary for the application of section 421(a) exist, section 421(b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 6-month periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421(d)(1)(A)(i) (see § 1.421-1(d)(2)(i)), such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421(d)(1)(A)(ii) (see § 1.421-1(d)(2)(ii)), such amount shall be whichever of the following amounts is lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421(b).

(ii) The application of the special rules provided in section 421(b) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 421(b), no income results to the individual under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis.*—If the special rules provided in section 421(b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). If the special rules provided in section 421(b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the

person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 421(b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples*.—The operation of section 421(b) may be illustrated by the following examples:

*Example (1)*. On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date is \$100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for \$150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of \$15 is includible in E's gross income for 1957, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), since such value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100. Since the share was sold for \$150, E realizes a gain of \$50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

*Example (2)*. Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for \$75, its fair market value on that date. Since \$75 is less than the option price (\$85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is \$85. Since E sold the share for \$75, E realized a loss of \$10 on the sale, which loss is treated as a long-term capital loss.

*Example (3)*. Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is \$120 per share so that E pays \$108 for the share of stock. Compensation in the amount of \$10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10, the lesser, is includible in gross income. In this situation, E's cost basis of \$108 is increased by \$10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$118. Since the share was sold for

\$150, E realizes a gain of \$32, which is treated as long-term capital gain.

*Example (4).* Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, \$15 is includible as compensation in E's gross income for 1957. E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

*Example (5).* Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

*Example (6).* Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death, such \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), since such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (7).* Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of \$150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

*Example (8).* Assume the same facts as in example (1) except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in E's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

*Example (9).* Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death. See

example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (10).* Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421(b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for \$150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock.*—(1) Section 421(c) provides that the special rules stated in section 421(a) and (b), if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421(c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A(c) of the Internal Revenue Code of 1939.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* If, with respect to stock transferred pursuant to the timely exercise of a restricted stock option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within six months after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) *Exercise after death.*—(1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither

the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within six months after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of § 1.421-4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of § 1.421-3(b), relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421(b), is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421(b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3) (i) If under section 421(b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the restricted stock option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 421(b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an

amount includible under section 421(b). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)-1.

(ii) The application of subdivision (i) may be illustrated by the following example:

*Example.* On June 1, 1953, E was granted a restricted stock option to purchase for \$85 one share of the stock of his employer. On such day, the fair market value of such stock was \$100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at \$30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for \$150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421(b) to include in its gross income as compensation the amount of \$15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(d) (6)(B) the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the restricted stock option, \$30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is \$10. Since \$15, the amount includible in gross income by reason of section 421(b), is less than the value for estate tax purposes of the option, only 15/30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15/30 of \$10, or \$5. The estate realizes a capital gain of \$50 since the \$15 which is included in the gross income of the estate is added to the \$85 paid for the stock in determining the basis of the stock, but the basis of the stock is not increased by reason of the inclusion of the restricted stock option in the estate (see section 1014(d)). No deduction under section 421(d) (6)(B) is allowable with respect to the \$50 capital gain.

(e) *Disqualifying disposition.*—The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within six months after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, the income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the extent

to which such deduction is allowable shall be determined as if such deduction was claimed for the taxable year of the transfer.

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING  
ACCOUNTING PERIODS

§ 1.441 STATUTORY PROVISIONS; PERIOD FOR COMPUTATION OF TAXABLE INCOME.

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(a) COMPUTATION OF TAXABLE INCOME.—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) TAXABLE YEAR.—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) ANNUAL ACCOUNTING PERIOD.—For purposes of this subtitle, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) CALENDAR YEAR.—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) FISCAL YEAR.—For purposes of this subtitle, the term "fiscal year" means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

(f) ELECTION OF YEAR CONSISTING OF 52-53 WEEKS.—

(1) GENERAL RULE.—A taxpayer who, in keeping his books, regularly computes his income on the basis of an annual period which varies from 52 to 53 weeks and ends always on the same day of the week and ends always—

(A) on whatever date such same day of the week last occurs in a calendar month, or

(B) on whatever date such same day of the week falls which is nearest to the last day of a calendar month,

may (in accordance with the regulations prescribed under paragraph (3)) elect to compute his taxable income for purposes of this subtitle on the basis of such annual period. This paragraph shall apply to taxable years ending after the date of the enactment of this title.

(2) SPECIAL RULES FOR 52-53-WEEK YEAR.—

(A) EFFECTIVE DATES.—In any case in which the effective date or the applicability of any provision of this title is expressed in terms of taxable years beginning or ending with reference to a specified date which is the first or last day of a month, a taxable year described in paragraph (1) shall (except for purposes of the computation under section 21) be treated—

(i) as beginning with the first day of the calendar month beginning nearest to the first day of such taxable year, or

(ii) as ending with the last day of the calendar month ending nearest to the last day of such taxable year,

as the case may be.

(B) CHANGE IN ACCOUNTING PERIOD.—In the case of a change from or to a taxable year described in paragraph (1)—

(i) if such change results in a short period (within the meaning of section 443) of 359 days or more, or of less than 7 days, section 443 (b) (relating to alternative tax computation) shall not apply;

(ii) if such change results in a short period of less than 7 days, such short period shall, for purposes of this subtitle, be added to and deemed a part of the following taxable year; and

(iii) if such change results in a short period to which subsection (b) of section 443 applies, the taxable income for such short

period shall be placed on an annual basis for purposes of such subsection by multiplying such income by 365 and dividing the result by the number of days in the short period, and the tax shall be the same part of the tax computed on the annual basis as the number of days in the short period is of 365 days.

(3) **REGULATIONS.**—The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this subsection.

(g) **No Books Kept; No Accounting Periods.**—Except as provided in section 443 (relating to returns for periods of less than 12 months), the taxpayer's taxable year shall be the calendar year if—

- (1) the taxpayer keeps no books;
- (2) the taxpayer does not have an annual accounting period; or
- (3) the taxpayer has an annual accounting period, but such period does not qualify as a fiscal year.

§ 1.441-1 **PERIOD FOR COMPUTATION OF TAXABLE INCOME.**—(a) *Computation of taxable income.*—Taxable income shall be computed and a return shall be made for a period known as the “taxable year.” For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see sections 446 to 482, inclusive, and the regulations thereunder.

(b) *Taxable year.*—(1) The term “taxable year” means—

- (i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;
- (ii) The calendar year, if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies; or
- (iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a “short period.”

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52-53-week taxable year. See § 1.441-2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see § 1.442-1(b)(2), section 706(b), and § 1.706-1(b). For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502-14 and § 1.442-1(d).

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442-1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706(b) and § 1.706-1(b).

(c) *Annual accounting period.*—The term “annual accounting period” means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.*—The term “calendar year” means a period of 12 months ending on December 31. A taxpayer who has not estab-



lished a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year*.—(1) The term “fiscal year” means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

(f) *Election of year consisting of 52–53 weeks*.—For rules relating to the 52–53-week taxable year, see § 1.441–2.

(g) *No books kept; no accounting period*.—Except in the case of a short period under section 443, the taxpayer’s taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period (as defined in section 441(c) and paragraph (c) of this section); or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year (as defined in section 441(e) and paragraph (e) of this section).

For the purposes of subparagraph (1) of this paragraph, the keeping of books does not require that records be bound. Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. A taxpayer whose taxable year is required to be a calendar year under section 441(g) and this paragraph may not adopt a fiscal year without obtaining prior approval from the Commissioner since such adoption is treated as a change of annual accounting period. See section 442 and § 1.442–1(a)(2).

§ 1.441–2 ELECTION OF YEAR CONSISTING OF 52–53 WEEKS.—(a) *General rule*.—Section 441 (f) provides, in general, that a taxpayer may elect to compute his taxable income on the basis of a fiscal year which—

(1) Varies from 52 to 53 weeks.

(2) Ends always on the same day of the week, and

(3) Ends always on—

(i) Whatever date this same day of the week last occurs in a calendar month, or

(ii) Whatever date this same day of the week falls which is nearest to the last day of the calendar month.

For example, if the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 1956, the taxable year would end on November 24, 1956. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 1956, the taxable year would end on December 1, 1956. Thus, in the case of a taxable year described in (3)(i), the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described

in (3) (ii), the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(b) *Application of effective dates.*—(1) For the purpose of determining the effective date for the applicability of any provision of this title which is expressed in terms of taxable years beginning or ending with reference to the first or last day of a specified calendar month, including the time for filing returns and other documents, paying tax, or performing other acts, a 52–53-week taxable year is deemed to begin on the first day of the calendar month beginning nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month ending nearest to the last day of the 52–53-week taxable year, as the case may be. The preceding sentence does not apply to the computation of tax if subparagraph (2) of this paragraph, relating to the computation under section 21 of the effect of changes in rates of tax during a taxable year, applies. The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 1957. For that purpose a 52–53-week taxable year beginning on any day within the period December 26, 1956, to January 4, 1957, inclusive, shall be treated as beginning on January 1, 1957.

*Example (2).* Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, shall be treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

(2) If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under subparagraph (1) of this paragraph), the tax for the 52–53-week taxable year shall be computed in accordance with section 21, relating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 21, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of subparagraph (1) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* Assume a change in the rate of tax is effective for taxable years beginning after June 30, 1956. For a 52–53-week taxable year beginning on Wednesday, November 2, 1955, the tax must be computed on the basis of the old rates for the actual number of days, from November 2, 1955, to June 30, 1956, inclusive, and on the basis of the new rates for the actual number of days from July 1, 1956, to Tuesday, October 30, 1956, inclusive.

*Example (2).* Assume a change in the rate of tax for taxable years beginning after June 30. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 21 will be required for such year because of the change in rate.

(c) *Adoption of or change to or from 52-53-week taxable year.*—

(1) A new taxpayer may adopt the 52-53-week taxable year for his first taxable year if he keeps his books and computes his income on that basis, or if he conforms his books accordingly in closing them. The taxpayer must thereafter keep his books and report his income on the basis of the 52-53-week taxable year so adopted unless prior approval for a change is obtained from the Commissioner. See subparagraph (4) of this paragraph. The taxpayer shall file with his return for his first taxable year a statement containing the information required in subparagraph (3) of this paragraph. A newly-formed partnership may adopt a 52-53-week taxable year without the permission of the Commissioner only if such a year ends either with reference to the same month in which the taxable years of all its principal partners end or with reference to the month of December. See § 1.706-1(b)(1).

(2) A taxpayer, including a partnership, may change to a 52-53-week taxable year without the permission of the Commissioner if the 52-53-week taxable year ends with reference to the end of the same calendar month as that in which the former taxable year ended, and if the taxpayer keeps his books and computes his income for the year of change on the basis of such 52-53-week taxable year, or if he conforms his books accordingly in closing them. The taxpayer must continue to keep his books and compute his income on the basis of such 52-53-week taxable year unless prior approval for a change is obtained. See subparagraph (4) of this paragraph. The taxpayer shall indicate his election to change to such 52-53-week taxable year by a statement filed with his return for the first taxable year for which the election is made. This statement shall contain the information required in subparagraph (3) of this paragraph.

(3) The statement referred to in subparagraphs (1) and (2) of this paragraph shall contain the following information:

(i) The calendar month with reference to which the new 52-53-week taxable year ends;

(ii) The day of the week on which the 52-53-week taxable year always will end; and

(iii) Whether the 52-53-week taxable year will always end on (a) the date on which such day of the week falls in the calendar month, or (b) on the date on which such day of the week falls which is nearest to the last day of such calendar month.

(4) Where a taxpayer wishes to change to a 52-53-week taxable year and, in addition, wishes to change the month with reference to which the taxable year ends, or where a taxpayer wishes to change from a 52-53-week taxable year, he must obtain prior approval from the Commissioner, as provided in section 442 and § 1.442-1.

(5) If a change from or to a 52-53-week taxable year results in a short period (within the meaning of section 443) of 359 days or more, or six days or less, the tax computation under section 443(b) shall not apply. If the short period is 359 days or more, it shall be treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but shall be added to and deemed a part of the following taxable year. (In the case of a change from or to a 52-53-week taxable year not involving a change of the month

with reference to which the taxable year ends, the tax computation under section 443(b) does not apply since the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days, but less than 359 days, taxable income for the short period shall be placed on an annual basis for the purpose of section 443(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period shall be the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless section 443(b)(2) and § 1.443-1(b)(2), relating to the alternative tax computation, apply). For adjustment in deduction for personal exemption, see section 443(c) and § 1.443-1(b)(1)(v).

(6) The provisions of subparagraph (5) are illustrated by the following examples:

*Example (1).* A taxpayer having a fiscal year ending April 30 elects for years beginning after April 30, 1955, a 52-53-week taxable year ending on the last Saturday in April. This election involves a short period of 364 days, from May 1, 1955, to April 28, 1956, inclusive. Since this short period is 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

*Example (2).* Assume the same conditions as in example (1), except that the taxpayer elects for years beginning after April 30, 1955, a taxable year ending on the Tuesday nearest to April 30. This election involves a short period of three days, from May 1 to May 3, 1955. Since this short period is less than seven days, tax is not separately computed for it. This short period is added to and deemed part of the following 52-week taxable year which would otherwise begin on May 4, 1955, and end on May 1, 1956. Thus, that taxable year is deemed to begin on May 1, 1955, and end on May 1, 1956.

(d) *Computation of taxable income.*—The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, are generally applicable to 52-53-week taxable years. Thus, items of income and deductions are determined on the basis of a 52-53-week taxable year, except that such items may be determined as though the 52-53-week taxable year were a taxable year consisting of 12 calendar months if such practice is consistently followed by the taxpayer and if income is clearly reflected thereby. In the case of depreciation, unless some other practice is consistently followed, the allowance shall be determined as though the 52-53-week year were a taxable year consisting of 12 calendar months. Amortization deductions for the taxable year shall be determined as though the 52-53-week year were a taxable year consisting of 12 calendar months.

(e) *Taxable years beginning before January 1, 1954, and ending after August 16, 1954.*—Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section relating to taxable years consisting of 52-53 weeks shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, which years are subject to the Internal Revenue Code of 1939.

§ 1442 STATUTORY PROVISIONS; CHANGE OF ANNUAL ACCOUNTING PERIOD.

SEC. 442. CHANGE OF ANNUAL ACCOUNTING PERIOD.

If a taxpayer changes his annual accounting period, the new accounting period shall become the taxpayer's taxable year only if the change is approved by the Secretary or his delegate. For purposes of this subtitle, if a taxpayer to whom section 441(g) applies adopts an annual accounting period (as defined in section 441(c)) other than a calendar year, the taxpayer shall be treated as having changed his annual accounting period.

§ 1.442-1(a) CHANGE OF ANNUAL ACCOUNTING PERIOD.—(1) *In general.*—If a taxpayer wishes to change his annual accounting period (as defined in section 441(c)) and adopt a new taxable year (as defined in section 441(b)), he must obtain prior approval from the Commissioner by application, as provided in paragraph (b) of this section, or the change must be authorized under the Income Tax Regulations. A new taxpayer who adopts an annual accounting period as provided in section 441 and §§ 1.441-1 or 1.441-2 need not secure the permission of the Commissioner under section 442 and this section. However, see subparagraph (2) of this paragraph. For adoption of and changes to or from a 52-53-week taxable year, see section 441(f) and § 1.441-2; for adoption of and changes in the taxable years of partners and partnerships, see paragraph (b) (2) of this section, section 706(b), and § 1.706-1(b); for special rules relating to certain corporations, subsidiary corporations, and newly married couples, see paragraphs (c), (d), and (e), respectively, of this section.

(2) *Taxpayers to whom section 441(g) applies.*—Section 441(g) provides that if a taxpayer keeps no books, does not have an annual accounting period, or has an accounting period which does not meet the requirements for a fiscal year, his taxable year shall be the calendar year. If section 441(g) applies to a taxpayer, the adoption of a fiscal year will be treated as a change in his annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. Approval of any such change will be denied unless the taxpayer agrees in his application to establish and maintain accurate records of his taxable income for the short period involved in the change and for the fiscal year proposed. The keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of section 441(g) and § 1.441-1 (g).

(b) *Prior approval of the Commissioner.*—(1) *In general.*—In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington 25, D. C., on or before the last day of the month following the close of the short period for which a return is required to effect the change of accounting period. In general, a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. If

the effect of the change is to defer a substantial portion of the taxpayer's income, or to shift a substantial portion of deductions, from one year to another so as to reduce substantially the tax liability of the taxpayer, the change will ordinarily not be approved. Further, approval will ordinarily be denied if the effect of the change is to cause a similar deferral or shifting in the case of another taxpayer, such as a partner, beneficiary, etc., so as to reduce substantially such other taxpayer's tax liability. In addition, a change will ordinarily not be approved if the short period resulting from the change is one in which there is a net operating loss. Among the non-tax factors that will be considered in determining whether a substantial business purpose has been established is the effect of the change on the taxpayer's annual cycle of business activity. However, even though a substantial business purpose is not established, the Commissioner in appropriate cases may permit a husband and wife to change his or her taxable year in order to secure the benefits of section 2 (relating to tax in case of joint return). See paragraph (e) of this section for special rule for newly married couples.

(2) *Partnerships and partners.*—(i) A newly-formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or is the same taxable year to which its principal partners who do not have such taxable year concurrently change) without securing prior approval from the Commissioner. If all its principal partners are not on the same taxable year, a newly-formed partnership may adopt a calendar year without securing prior approval from the Commissioner. If a newly-formed partnership wishes to adopt a taxable year that does not qualify under the preceding two sentences, the adoption of such year requires the prior approval of the Commissioner in accordance with section 706(b)(1) and § 1.706-1(b). An existing partnership may change its taxable year without securing prior approval from the Commissioner if all its principal partners have the same taxable year to which the partnership changes, or if all its principal partners who do not have such a taxable year concurrently change to such taxable year. In any other case, an existing partnership may not change its taxable year unless it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section and section 706(b)(1) and § 1.706-1(b).

(ii) A partner may change his taxable year only if he secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section.

(c) *Special rule for certain corporations.*—(1) A corporation may change its annual accounting period without the prior approval of the Commissioner if all the conditions in subparagraph (2) of this paragraph are met, and if the corporation files a statement with the district director of internal revenue with whom the returns of the corporation are filed at or before the time (including extensions) for filing the return for the short period required by such change. This statement shall indicate that the corporation is changing its annual accounting period under § 1.442-1(c) and shall contain information indicating that all of the conditions in subparagraph (2) of this paragraph have been met.

(2) The provisions of this paragraph do not apply unless all of the following conditions are met:

(i) The corporation has not changed its annual accounting period at any time within the ten calendar years ending with the calendar year which includes the beginning of the short period required to effect the change of annual accounting period;

(ii) The short period required to effect the change of annual accounting period is not a taxable year in which the corporation has a net operating loss as defined in section 172;

(iii) The taxable income of the corporation for the short period required to effect the change of annual accounting period is, if placed on an annual basis (see § 1.443-1(b)(1)(i) and (ii)), 80 percent or more of the taxable income of the corporation for the taxable year immediately preceding such short period; and

(iv) If a corporation had a special status (described in the following sentence) either for the short period or for the taxable year immediately preceding such short period, it must have the same special status for both the short period and such taxable year. For the purpose of the preceding sentence, special status includes only: a personal holding company, a foreign personal holding company, a corporation which is an exempt organization, a foreign corporation not engaged in trade or business within the United States, a Western Hemisphere trade corporation, and a China Trade Act corporation.

(3) If the Commissioner finds upon examination of the returns that the corporation, because of subsequent adjustments in establishing tax liability, did not in fact meet all the conditions in subparagraph (2) of this paragraph, the statement filed under subparagraph (1) of this paragraph shall be considered as a timely application for permission to change the corporation's annual accounting period to the taxable year indicated in the statement.

(d) *Special rule for change of annual accounting period by subsidiary corporation.*—A subsidiary corporation which is required to change its annual accounting period under § 1.1502-14, relating to the accounting period of an affiliated group which files a consolidated income tax return, may do so by filing Form 1128 with the district director with whom the consolidated return is filed. Such form shall be filed in accordance with that section. See also §§ 1.1502-13(h) and 1.1502-32.

(e) *Special rule for newly married couples.*—(1) A newly married husband or wife may change his or her annual accounting period in order to adopt the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of such spouse ending after the date of marriage, provided that the newly married husband or wife adopting the annual accounting period of the other spouse files a return for the short period required by such change on or before the 15th day of the 4th month following the close of such short period. See section 443 and the regulations thereunder. (If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph.) The short-period return shall contain a statement that it is filed un-

der authority of § 1.442-1(e). For a change of annual accounting period by a husband or wife which does not qualify under this subparagraph, see paragraph (b) of this section.

(2) The provisions of this paragraph may be illustrated by the following example:

*Example.* H & W marry on September 25, 1956. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 1956. H may not change to a calendar year for 1956 since, under § 1.442-1(e), he would have had to file a return for the short period from July 1 to December 31, 1955, by April 15, 1956. Since the date of marriage occurred subsequent to this due date, the return could not be filed under § 1.442-1(e). Therefore, H cannot change to a calendar year for 1956. However, H may change to a calendar year for 1957 by filing a return under § 1.442-1(e) by April 15, 1957, for the short period from July 1 to December 31, 1956. If H files such a return, H and W may file a joint return for calendar year 1957 (which is W's second taxable year ending after the date of marriage).

(f) *Effective date.*—The provisions of this section (other than paragraph (e) thereof) are effective for any change of annual accounting period where the last day of the short period to effect the change ends on or after the date the regulations under section 442 are published in the Federal Register [March 1, 1957].

## § 1.443 STATUTORY PROVISIONS; RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS.

### SEC. 443. RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS.

(a) RETURNS FOR SHORT PERIOD.—A return for a period of less than 12 months (referred to in this section as "short period") shall be made under any of the following circumstances:

(1) CHANGE OF ANNUAL ACCOUNTING PERIOD.—When the taxpayer, with the approval of the Secretary or his delegate, changes his annual accounting period. In such a case, the return shall be made for the short period beginning on the day after the close of the former taxable year and ending at the close of the day before the day designated as the first day of the new taxable year.

(2) TAXPAYER NOT IN EXISTENCE FOR ENTIRE TAXABLE YEAR.—When the taxpayer is in existence during only part of what would otherwise be his taxable year.

(3) TERMINATION OF TAXABLE YEAR FOR JEOPARDY.—When the Secretary or his delegate terminates the taxpayer's taxable year under section 6851 (relating to tax in jeopardy).

(b) COMPUTATION OF TAX ON CHANGE OF ANNUAL ACCOUNTING PERIOD.—

(1) GENERAL RULE.—If a return is made under paragraph (1) of subsection (a), the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. The tax shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(2) EXCEPTION.—

(A) COMPUTATION BASED ON 12-MONTH PERIOD.—If the taxpayer applies for the benefits of this paragraph and establishes the amount of his taxable income for the 12-month period described in subparagraph (B), computed as if that period were a taxable year and under the law applicable to that year, then the tax for the short period,



computed under paragraph (1), shall be reduced to the greater of the following:

(i) an amount which bears the same ratio to the tax computed on the taxable income for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for the 12-month period; or

(ii) the tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

The taxpayer (other than a taxpayer to whom subparagraph (B) (ii) applies) shall compute the tax and file his return without the application of this paragraph.

(B) 12-MONTH PERIOD.—The 12-month period referred to in subparagraph (A) shall be—

(i) the period of 12 months beginning on the first day of the short period, or

(ii) the period of 12 months ending at the close of the last day of the short period, if at the end of the 12 months referred to in clause (i) the taxpayer is not in existence or (if a corporation) has theretofore disposed of substantially all of its assets.

(C) APPLICATION FOR BENEFITS.—Application for the benefits of this paragraph shall be made in such manner and at such time as the regulations prescribed under subparagraph (D) may require; except that the time so prescribed shall not be later than the time (including extensions) for filing the return for the first taxable year which ends on or after the day which is 12 months after the first day of the short period. Such application, in case the return was filed without regard to this paragraph, shall be considered a claim for credit or refund with respect to the amount by which the tax is reduced under this paragraph.

(D) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this paragraph.

(c) ADJUSTMENT IN DEDUCTION FOR PERSONAL EXEMPTION.—In the case of a taxpayer other than a corporation, if a return is made for a short period by reason of subsection (a) (1) and if the tax is not computed under subsection (b) (2), then the exemptions allowed as a deduction under section 151 (and any deduction in lieu thereof) shall be reduced to amounts which bear the same ratio to the full exemptions as the number of months in the short period bears to 12.

(d) CROSS REFERENCES.—For inapplicability of subsection (b) in computing—

(1) Accumulated earnings tax, see section 536.

(2) Personal holding company tax, see section 546.

(3) Undistributed foreign personal holding company income, see section 557.

(4) The taxable income of a regulated investment company, see section 852(b) (2) (E).

§ 1.443-1 RETURNS FOR PERIODS OF LESS THAN 12 MONTHS.—(a) *Returns for short period.*—A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) *Change of annual accounting period.*—In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52-53-week taxable year. See section 441(f) and § 1.441-2. The computation of the tax for a short period required to effect a change of annual accounting period

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is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a taxable year of 12 months ending on the last day of the short period. For a subsidiary corporation required to change its annual accounting period under § 1.1502-14, see §§ 1.1502-13, 1.1502-32, and 1.442-1(d).

(2) *Taxpayer not in existence for entire taxable year.*—If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443(c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(3) *Termination of taxable year for jeopardy.*—A return must be filed for a short period resulting from the termination by the Commissioner of a taxpayer's taxable year for jeopardy. See section 6851 and the regulations thereunder.

(b) *Computation of tax for short period on change of annual accounting period.*—(1) *General rule.*—(i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443(b)(2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52-53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441(f)(2)(B)(iii) and § 1.441-2(c)(5).

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see §§ 1.1502-32 and 1.1502-14.

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142(b)(3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443(b)(1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642(b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52-53-week taxable year to which section 441(f)(2)(B)(iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under section 34 and 35 for dividends received and for partially tax-exempt interest, respectively) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

(vii) The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

<b>INCOME</b>	
Interest income .....	\$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35 .....	500.00
Dividends to which section 34 and 116 are applicable.....	750.00
	<hr/>
	\$11,250.00
<b>DEDUCTIONS</b>	
Real estate taxes .....	200.00
2 personal exemptions at \$600 on an annual basis.....	1,200.00

The tax for the 10-month period is computed as follows:

Total income as above.....	\$11,250.00
Less:	
Exclusion for dividends received.....	\$50.00
2 personal exemptions (\$1,200×10/12).....	1,000.00
Real estate taxes .....	200.00
	<hr/>
	1,250.00

Taxable income for 10-month period before annualizing.....	\$10,000.00
Taxable income annualized ( $\$10,000 \times 12/10$ ).....	12,000.00
Tax on \$12,000 before credits.....	3,400.00
Deduct credits:	
Dividends received for 10-month period.....	\$750.00
Less: Excluded portion .....	50.00
	<hr/>
Included in gross income.....	\$700.00
Dividend income annualized ( $\$700 \times 12/10$ ).....	\$840.00
Credit (4% of \$840).....	\$33.60
Partially tax-exempt interest included in gross income for 10-month period.....	\$500.00
Partially tax-exempt interest (annualized) ( $\$500 \times 12/10$ ) .....	600.00
Credit (3% of \$600).....	18.00
	<hr/>
	51.60
Tax on \$12,000 (after credits).....	<hr/> \$3,348.40
Tax for 10-month period ( $\$3,348.40 \times 10/12$ ).....	<hr/> <hr/> \$2,790.33

*Example (2).* The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income .....	\$126,000
Business expenses .....	130,000
	<hr/>
Net loss from operations.....	\$(4,000)
Dividends received from taxable domestic corporations.....	30,000
	<hr/>
Gross income for short period before annualizing.....	\$26,000
Dividends received deduction (85% of \$30,000, but not in excess of 85% of \$26,000) .....	22,100
	<hr/>
Taxable income for short period before annualizing.....	\$3,900
Taxable income annualized ( $\$3,900 \times 12$ ) .....	\$46,800
	<hr/>
Tax on annual basis: \$46,800 at 52%.....	\$24,336
Less surtax exemption .....	5,500
	<hr/>
	\$18,836
	<hr/>
Tax for one-month period ( $\$18,836 \times \frac{1}{12}$ ).....	<hr/> <hr/> \$1,570

*Example (3).* The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain.....	\$40,000
Net long-term capital gain.....	10,000
	<hr/>
Taxable income for short period before annualizing.....	\$50,000
	<hr/>
Taxable income annualized ( $\$50,000 \times \frac{12}{6}$ ).....	\$100,000
	<hr/>
REGULAR TAX COMPUTATION:	
Taxable income annualized .....	<hr/> <hr/> \$100,000

Tax on annual basis:	
\$100,000 at 52 percent .....	\$52,000
Less surtax exemption .....	5,500
	<u>\$46,500</u>
Tax for 6-month period ( $\$46,500 \times \frac{1}{12}$ ) .....	<u>\$23,250</u>
ALTERNATIVE TAX COMPUTATION:	
Taxable income annualized .....	\$100,000
Less annualized capital gain ( $\$10,000 \times 1\%$ ) .....	20,000
	<u>\$80,000</u>
Annualized taxable income subject to partial tax .....	<u>\$80,000</u>
PARTIAL TAX ON ANNUAL BASIS:	
\$80,000 at 52 percent .....	\$41,600
Less surtax exemption .....	5,500
	<u>\$36,100</u>
25% of annualized capital gain (\$20,000) .....	<u>5,000</u>
Alternative tax on annual basis .....	<u>\$41,100</u>
Alternative tax for 6-month period ( $\$41,100 \times \frac{1}{12}$ ) .....	<u>\$20,550</u>

Since the alternative tax of \$20,550 is less than the tax computed in the regular manner (\$23,250), the corporation's tax for the 6-month short period is \$20,550.

(2) *Exception: computation based on 12-month period.*—(i) A taxpayer whose tax would otherwise be computed under section 443(b) (1) (or section 441(f) (2) (B) (iii) in the case of certain changes from or to a 52–53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443(b) (2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(a) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or

(b) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis. However, if the tax computed under section 443(b) (2) and this subparagraph is not less than the tax for the short period computed under section 443(b) (1) (or section 441(f) (2) (B) (iii) in the case of certain changes from or to a 52–53-week taxable year), then section 443(b) (2) and this subparagraph do not apply.

(ii) The term “12-month period” referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term “12-month period” means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased

business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52-53-week taxable year, the term "12-month period" means the period of 52 or 53 weeks (depending on the taxpayer's 52-53-week taxable year) beginning on the first day of the short period.

(iii) (a) The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period on such manner as will most clearly reflect income for the 12-month period.

(b) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(c) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443(b)(2). Such closing inventory will be used only for the purposes of section 443(b)(2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* The taxpayer in example (1) under paragraph (b)(1) establishes his taxable income for the 12-month period from January 1, 1956, to December 31, 1956. The taxpayer has a short

period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision (v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

<b>INCOME</b>		
Interest income .....	\$11,000	
Partially tax-exempt interest with respect to which a credit is allowable under section 35 .....	600	
Dividends to which sections 34 and 116 are applicable.....	850	
		<u>\$12,450</u>
<b>DEDUCTIONS</b>		
Real estate taxes .....	200	
2 personal exemptions at \$600 .....	1,200	
<b>TAX COMPUTATION FOR SHORT PERIOD UNDER SECTION 443(b)(2)(A)(i)</b>		
Total income as above .....	\$12,450	
Less:		
Exclusion for dividends received .....	\$50	
Personal exemptions .....	1,200	
Deduction for taxes .....	200	<u>1,450</u>
Taxable income for 12-month period .....	\$11,000	
Tax before credits .....	3,020	
Credit for partially tax-exempt interest (3% of \$600) .....	\$18	
Credit for dividends received (4% of (\$850—50)) .....	32	<u>50</u>
Tax under section 443(b)(2)(A)(i) for 12-month period.....	\$2,970	
Taxable income for 10-month short period from example (1) of paragraph (b)(1) before annualizing .....	\$10,000	
Tax for short period under section 443(b)(2)(A)(i) ( $\$2,970 \times \$10,000$ (taxable income for short period)/\$11,000 (taxable income for 12-month period)) .....	\$2,700	
<b>TAX COMPUTATION FOR SHORT PERIOD UNDER SECTION 443(b)(2)(A)(ii)</b>		
Total income for 10-month short period.....	\$11,250	
Less:		
Exclusion for dividends received .....	\$50	
2 personal exemptions .....	1,200	
Real estate taxes .....	200	<u>1,450</u>
Taxable income for short period without annualizing and without proration of personal exemptions .....	\$9,800	
Tax before credits .....	2,572	
Less credits:		
Partially tax-exempt interest (3% of \$500) .....	\$15	
Dividends received (4% of (\$750—50)) .....	28	<u>43</u>
Tax for short period under section 443(b)(2)(A)(ii) .....	\$2,529	

The tax of \$2,700 computed under section 443(b)(2)(A)(i) is greater than the tax of \$2,529, computed under section 443(b)(2)(A)(ii), and is, therefore, the tax under section 443(b)(2). Since the tax of \$2,700 (computed under section 443(b)(2)) is less than the tax of \$2,790.33 (computed under section 443(b)(1)) on the annualized income of the short period (see example (1) of paragraph (b)(1)), the taxpayer's tax for the 10-month short period is \$2,700.

*Example (2).* Assume the same facts as in example (1) of this subdivision, except that, during the month of November 1956, the

taxpayer suffered a casualty loss of \$5,000. The tax computation for the short period under section 443(b)(2) would be as follows:

TAX COMPUTATION FOR SHORT PERIOD UNDER SECTION 443(b)(2)(A)(i)		
Taxable income for 12-month period from example (1).....	\$11,000	
Less: Casualty loss .....	5,000	
	<u>          </u>	
Taxable income for 12-month period .....	\$6,000	
	<u>          </u>	
Tax before credits .....	\$1,360	
Credits from example (1) .....	50	
	<u>          </u>	
Tax under section 443(b)(2)(A)(i) for 12-month period.....	\$1,310	
	<u>          </u>	
Tax for short period ( $\$1,310 \times \$10,000/\$6,000$ ) under section 443(b)(2)(A)(i) .....	\$2,183	
	<u>          </u>	
TAX COMPUTATION FOR SHORT PERIOD UNDER SECTION 443(b)(2)(A)(ii)		
Total income for the short period.....	\$11,250	
Less:		
Exclusion for dividends received.....	\$50	
2 personal exemptions .....	1,200	
Real estate taxes .....	200	1,450
	<u>          </u>	
Taxable income for short period without annualizing and without proration of personal exemptions .....	\$9,800	
Tax before credits .....	2,572	
Less credits:		
Partially tax-exempt interest (3% of \$500) .....	\$15	
Dividends received (4% of (\$750-50)) .....	28	43
	<u>          </u>	
Tax for short period under section 443(b)(2)(A)(ii).....	\$2,529	
	<u>          </u>	

The tax of \$2,529, computed under section 443(b)(2)(A)(ii) is greater than the tax of \$2,183 computed under section 443(b)(2)(A)(i) and is, therefore, the tax under section 443(b)(2). Since this tax is less than the tax of \$2,790.33, computed under section 443(b)(1) (see example (1) of paragraph (b)(1)), the taxpayer's tax for the 10-month short period is \$2,529.

(v) (a) A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443(b)(2) must make an application therefor. Except as provided in subdivision (b), the taxpayer shall first file his return for the short period and compute his tax under section 443(b)(1). The application for the benefits of section 443(b)(2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443(b)(2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file



his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443(b)(2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(b) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443(b)(2)(B)(ii) and subparagraph (2)(ii) of this paragraph) will be used in the computations under section 443(b)(2), then the tax on the return for the short period may be determined under the provisions of section 443(b)(2). In such case, a return covering the 12-month period shall be attached to the return for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443(b)(2).

(c) *Adjustment in deduction for personal exemption.*—For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443(b)(1) (or under section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52-53-week taxable year), see paragraph (b)(1)(v) of this section.

(d) *Cross references.*—For inapplicability of section 443(b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder; and

(4) The taxable income of a regulated investment company, see section 882(b)(2)(E) and the regulations thereunder.

#### METHODS OF ACCOUNTING

##### METHODS OF ACCOUNTING IN GENERAL

### § 1.446 STATUTORY PROVISIONS; GENERAL RULE FOR METHODS OF ACCOUNTING.

#### SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) **GENERAL RULE.**—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) **EXCEPTIONS.**—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) **PERMISSIBLE METHODS.**—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) The cash receipts and disbursements method;

(2) An accrual method;

(3) Any other method permitted by this chapter; or

### § 1.443-1(c)

(4) Any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) **TAXPAYER ENGAGED IN MORE THAN ONE BUSINESS.**—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) **REQUIREMENT RESPECTING CHANGE OF ACCOUNTING METHOD.**—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

§ 1.446-1 **GENERAL RULE FOR METHODS OF ACCOUNTING.**—(a) *General rule.*—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term “method of accounting” includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return as, for example, a reconciliation of any differences between such books and his return. The following are among the

essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*—(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods.*—(1) *In general.*—Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461-1(a) (1).

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting and is consistently used by the taxpayer from year to

year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or while title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.*—Special methods of accounting are described elsewhere in chapter 1 of the Internal Revenue Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*—(a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*—(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the Income Tax Regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though

not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.*—(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.*—(1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2) (i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expenses, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventory goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

#### TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

### § 1.451 STATUTORY PROVISIONS; GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

#### SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) **GENERAL RULE.**—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

(b) **SPECIAL RULE IN CASE OF DEATH.**—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death.

§ 1.451-1 **GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.**—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income

and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) *Special rule in case of death.*—(1) A taxpayer's taxable year ends on the date of his death. See section 443(a) (2) and § 1.443-1(a) (2). In computing taxable income for such year, there shall be included only amounts properly includible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing taxable income for such year. If the taxpayer uses no regular accounting method, only amounts actually or constructively received during such year shall be included. (For rules relating to the inclusion of partnership income in the return of a decedent partner, see subchapter K of chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder.)

(2) If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation. See section 453(d) (3). For the treatment of installment obligations, acquired by the decedent's estate or by any person by bequest, devise, or inheritance from the decedent, see section 691(a) (4) and the regulations thereunder.

§ 1.451-2 CONSTRUCTIVE RECEIPT OF INCOME.—(a) *General rule.*—Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the

§ 1.451-1(b)

taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

(b) *Examples of constructive receipt.*—Interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been constructively received until January. Interest on savings bank deposits is income to the depositor when credited on the books of the bank, even though the bank has a rule, seldom or never enforced, that it may require a certain number of days' notice before withdrawals are permitted. Generally, the amount of dividends or interest credited to shareholders of organizations such as building and loan associations or cooperative banks, is income to the shareholders for the taxable year when credited. However, if the amount of such dividends or interest is not available for the shareholders' free and unrestricted use at the time credited, such amount is not constructively received and does not constitute income to the shareholder until the taxable year in which the amount is available. Accordingly, if the amount of dividends or interest is accumulated and is not available to the shareholder until the maturity of a share, the crediting thereof to the shareholder's account does not constitute constructive receipt. However, in such a case the total amount credited is income to the shareholder in the year of maturity.

§ 1.451-3 LONG-TERM CONTRACTS.—(a) *Definition.*—The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.*—Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.*—Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract.



Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method*.—Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(c) *In general*.—Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not attributable to such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446-1(c). A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446(e) and § 1.446-1(e). When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

§ 1.451-4 ACCOUNTING FOR REDEMPTION OF TRADING STAMPS AND COUPONS.—(a) If a taxpayer issues trading stamps or premium coupons with sales, which stamps or coupons are redeemable in merchandise or cash, he should, in computing the income from such sales, subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file a statement showing with respect to each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, the following:

- (1) The total issue of stamps or coupons during each year;
- (2) The total stamps or coupons redeemed in each year; and
- (3) Such other information as is necessary to establish the correctness of the amount subtracted from sales in each of such years.

(b) Upon examination of the return, the amount subtracted in respect of such coupons will be adjusted if, in the opinion of the Commissioner, such amount is incorrectly computed.

#### § 1.454 STATUTORY PROVISIONS; OBLIGATIONS ISSUED AT DISCOUNT. SEC. 454. OBLIGATIONS ISSUED AT DISCOUNT.

(a) *NONINTEREST-BEARING OBLIGATIONS ISSUED AT A DISCOUNT*.—If, in the case of a taxpayer owning any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (c), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his taxable income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year, treat such increase as income received in such taxable year. If any such election is

made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless on application by the taxpayer the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (c), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(b) **SHORT-TERM OBLIGATIONS ISSUED ON DISCOUNT BASIS.**—In the case of any obligation—

(1) of the United States; or

(2) of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia,

which is issued on a discount basis and payable without interest at a fixed maturity date not exceeding 1 year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(c) **MATURED UNITED STATES SAVINGS BONDS.**—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than 10 years from the date of maturity of such series E bond, the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. This subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for which an election made by the taxpayer under subsection (a) applies.

§ 1.454-1 **OBLIGATIONS ISSUED AT DISCOUNT.**—(a) *Non-interest-bearing obligations issued at discount.*—(1) If a taxpayer—

(i) Owns any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, or

(ii) Retains his investment in the maturity value of a series E United States savings bond, in the manner described in section 454(c)(2), and

if the increase in redemption price of such obligation, described in subdivision (i) or (ii) of this subparagraph, occurring in the taxable year does not constitute income for such year under the method of accounting used in computing his taxable income, then the taxpayer may, at his election, treat the increase as constituting income for the year in which such increase occurs, rather than for the year in which the obligation is disposed of, redeemed, paid at maturity, or converted into a current income obligation of the United States (such as a bond of series G or K). Any such election must be made in the taxpayer's return and may be made for any taxable year. If an election is made with respect to any such obligation, it shall apply also to all other obligations of the type described in the paragraph

owned by the taxpayer at the beginning of the first taxable year to which the election applies and to those thereafter acquired by him, and shall be binding for the taxable year for which the return is filed and for all subsequent taxable years, unless the Commissioner permits the taxpayer to change to a different method of reporting income from such obligations. See section 446(e) and § 1.446-1(c), relating to requirements respecting a change of accounting method. Although the election once made is binding upon the taxpayer, it does not apply to a transferee of the taxpayer.

(2) In any case in which an election is made under section 454, the amount which accrues in any taxable year to which the election applies is measured by the actual increase in the redemption price occurring in that year. This amount does not accrue ratably between the dates on which the redemption price changes. For example, if two dates on which the redemption price increases (February 1 and August 1) fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount accruing in that year would be \$1.00 (\$0.50 on February 1 and \$0.50 on August 1). If the taxpayer owns a non-interest-bearing obligation of the character described in subparagraph (1) of this paragraph acquired prior to the first taxable year to which his election applies, he must also include in gross income for such first taxable year the increase in the redemption price of such obligation occurring between the date of acquisition of the obligation (or the series E bond involved in the case of a matured United States savings bond), and the first day of such first taxable year.

(3) The provisions of this paragraph are illustrated by the following example:

*Example.* Throughout the calendar year 1954, a taxpayer who computes his taxable income under the cash receipts and disbursements method holds series E United States savings bonds having a maturity value of \$5,000 and a redemption value at the beginning of the year 1954 of \$4,050 and at the end of the year 1954 of \$4,150. He purchased the bonds on January 1, 1949, for \$3,750, and holds no other obligation of the type described in this section. If the taxpayer exercises the election in his return for the calendar year 1954, he is required to include \$400 in taxable income with respect to such bonds. Of this amount, \$300 represents the increase in the redemption price before 1954 and \$100 represents the increase in the redemption price in 1954. The increases in redemption value occurring in subsequent taxable years are includible in gross income for such taxable years.

(b) *Short-term obligations issued on a discount basis.*—In the case of obligations of the United States or any of its possessions, or of a State, or Territory, or any political subdivision thereof, or of the District of Columbia, issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation originally sold does not accrue until the date on which such obligation is redeemed, sold, or otherwise disposed of. This rule applies regardless of the method of accounting used by the taxpayer. For example illustrating rules for computation of income

from sale or other disposition of certain obligations of the type described in this paragraph, see section 1221 and the regulations thereunder.

(c) *Matured United States savings bonds*.—If a taxpayer (other than a corporation) holds a series E United States savings bond at the date of maturity, and under the regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than 10 years from the date of maturity of such series E bond, the increase in redemption value not previously includible in gross income in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of section 454(c) and of this paragraph shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for a taxable year for which an election made by the taxpayer under section 454(a) and paragraph (a) of this section applies.

#### TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

### § 1.461 STATUTORY PROVISIONS; GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

#### SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) **GENERAL RULE**.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(b) **SPECIAL RULE IN CASE OF DEATH**.—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued as a deduction or credit only by reason of the death of the taxpayer shall not be allowed in computing taxable income for the period in which falls the date of the taxpayer's death.

#### (c) **ACCRUAL OF REAL PROPERTY TAXES**.—

(1) **IN GENERAL**.—If the taxable income is computed under an accrual method of accounting, then, at the election of the taxpayer, any real property tax which is related to a definite period of time shall be accrued ratably over that period.

(2) **SPECIAL RULES**.—Paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 for a taxable year which began before January 1, 1954. In the case of any real property tax which would, but for this subsection, be allowable as a deduction for the first taxable year of the taxpayer which begins after December 31, 1953, then, to the extent that such tax is related to any period before the first day of such first taxable year, the tax shall be allowable as a deduction for such first taxable year.

#### (3) **WHEN ELECTION MAY BE MADE**.—

(A) **WITHOUT CONSENT**.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this subsection for his first taxable year which begins after December 31, 1953, and ends after the date of enactment of this title in which the taxpayer incurs real property taxes. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) **WITH CONSENT**.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this subsection at any time.

§ 1.461-1 GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.—(a) *General rule.*—(1) *Taxpayer using cash receipts and disbursements method.*—Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims \$10,000. B admits the liability to A for \$5,000 but contests the remainder. B may accrue only \$5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.*—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for

credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165(e), relating to losses resulting from theft.

(4) *Deductions attributable to certain foreign income.*—In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See § 1.905-1(b) for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) *Special rule in case of death.*—A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and § 1.443-1(a)(2). In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K of chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder.

(c) *Accrual of real property taxes.*—(1) *In general.*—If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446(c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to \$1,200. Under section 461(c), § 600 of

such taxes accrue in the calendar year 1955, and the balance accrue in 1956. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules.*—(i) *Effective date.*—Section 461(c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954 would, but for section 461(c), be deductible in such first taxable year the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461(c)(1)).

(3) *When election may be made.*—(i) *Without consent.*—A taxpayer may elect to accrue real property taxes ratably in accordance with section 461(c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(a) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(b) The period of time to which the taxes are related; and

(c) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent.*—A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461(c) and this paragraph. A written request for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year to which the election is first applicable, or within 90 days after the date of the publication in the Federal Register of the regulations under section 461, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property taxes relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election.*—An election to accrue real property

taxes ratably under section 461(c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446 (e) and § 1.446-1(e) to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461(c) is applicable falls before the 90th day after the date the regulations under section 461 are published in the Federal Register, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461(c). If the taxpayer revokes his election under the preceding sentence, he must, on or before such 90th day, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before such 90th day.

(5) *Apportionment of taxes on real property between seller and purchaser.*—For apportionment of taxes on real property between seller and purchaser, see section 164(d) and the regulations thereunder.

(6) *Examples.*—The provisions of this paragraph are illustrated by the following examples:

*Example (1).* A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461(c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are \$1,200 for 1954; \$1,600 for 1955; and \$1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

*Fiscal year ending June 30, 1955:*

July through December 1954 .....	None <sup>1</sup>
January through June (6/12 of \$1,600) .....	\$800
Deduction for fiscal year ending June 30, 1955 .....	<u>\$800</u>

*Fiscal year ending June 30, 1956:*

July through December 1955 (6/12 of \$1,600) .....	\$800
January through June 1956 (6/12 of \$1,800) .....	900
Deduction for fiscal year ending June 30, 1956 .....	<u>\$1,700</u>

<sup>1</sup> The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

*Example (2).* A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are \$1,200; \$1,600 for the year ending June 30, 1955; and \$1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:



*Year ending December 31, 1954:*

January through June 1954 .....	None <sup>1</sup>
July through December 1954 (6/12 of \$1,600) .....	\$800
Deduction for year ending December 31, 1954 .....	<u>\$800</u>

*Year ending December 31, 1955:*

January through June 1955 (6/12 of \$1,600) .....	\$800
July through December 1955 (6/12 of \$1,800) .....	900
Deduction for year ending December 31, 1955 .....	<u>\$1,700</u>

<sup>1</sup> The entire tax of \$1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

*Example (3).* A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23(c) of the Internal Revenue Code of 1939.

*Example (4).* A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461(c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are \$1,200 for 1954; \$1,600 for 1955; and \$1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

*Fiscal year ending March 31, 1955:*

April through December 1954 (9/12 of \$1,200) .....	\$900
January through March 1955 (3/12 of \$1,600) .....	400
Taxes accrued ratably in fiscal year ending March 31, 1955 .....	\$1,300
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of \$1,200) ..	300
Deduction for fiscal year ending March 31, 1955 .....	<u>\$1,600</u>

*Fiscal year ending March 31, 1956:*

April through December 1955 (9/12 of \$1,600) .....	\$1,200
January through March 1956 (3/12 of \$1,800) .....	450
Deduction for fiscal year ending March 31, 1956 .....	<u>\$1,650</u>

NATURAL RESOURCES  
SALES AND EXCHANGES

**§ 1.631 STATUTORY PROVISIONS; GAIN OR LOSS IN THE CASE OF  
TIMBER OR COAL.**

**SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.**

(a) **ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.**—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for

sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

(b) **DISPOSAL OF TIMBER WITH A RETAINED ECONOMIC INTEREST.**—In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

(c) **DISPOSAL OF COAL WITH A RETAINED ECONOMIC INTEREST.**—In the case of the disposal of coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word "owner" means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b) (6) or section 545(b) (5)).

#### § 1.631-1 ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—

(a) *Effect of election.*—(1) Section 631(a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market

value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631(a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631(a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than six months prior to the beginning of the taxable year in which such timber is cut for sale or for use in the taxpayer's trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer's trade or business (for example, firewood cut for the taxpayer's own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) *Who may make election.*—(1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than six months before the beginning of the taxable year may elect under section 631(a) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. In order to have a "contract right to cut timber" within the meaning of section 631(a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631(a) and this section, the term "timber" includes evergreen trees which are more than six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631(a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(a). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) *Manner of making election.*—The election under section 631(a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be

made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631(a) and section 1231.

(d) *Computation of gain or loss under the election.*—(1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631(a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at the date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631(a), the timber so cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than six months depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) *Computation of subsequent gain or loss.*—(1) In case the products of the timber are sold after cutting, either in the form of logs or

lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631(a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the products so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631(a), are sold during a subsequent taxable year, whether or not the election provided in section 631(a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631(a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in-first-out inventory method provided by section 472 if such section is applicable to, and has been elected by, the taxpayer.

§ 1.631-2 GAIN OR LOSS UPON THE DISPOSAL OF TIMBER UNDER CUTTING CONTRACT.—(a) *In general.*—(1) If an owner disposes of timber held for more than six months before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e) (2) of this section for definition of "owner". For the purpose of determining whether or not the timber disposed of was held for more than six months before such disposal, the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have

been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than six months will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal.*—(1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E of chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder. See paragraph (c) (2) of this section for the effect of exercising the election with respect to the payment for timber held for six months or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the “date such timber is cut” means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as the date of disposal.*—(1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer’s income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631(b) expire before the close of the 90th day after the regulations adopted under section 631 are published in the Federal Register.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made six months or less from the date the timber disposed of was acquired, section 631(b) shall not apply to such payment, irrespective of the date such timber is cut, since the timber was not held for more than six months prior to disposal.

(d) *Payments received in advance of cutting.*—(1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631 (b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if

no election has been made under paragraph (c), amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than six months after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3) (i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than six months.

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

*Example.* Taxpayer A has held timber having a depletion basis of \$90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of \$5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be \$95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{amount of expected royalties}} \times \text{Basis of Timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5,000}{\$100,000} \times \$90,000 = \$4,500$$

(iii) To the extent attributable to timber not held for more than six months, such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than six months, the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

*Example.* Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for six months or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the

bonus attributable to these units is determined by the following formula:

$$\frac{\text{Number of units cut held for six months or less}}{\text{Total units covered by the contract}} \times \text{Amount of bonus} = \text{Amount of bonus treated as ordinary income subject to depletion}$$

$$\frac{10,000}{50,000} \times \$5,000 = \$1,000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

$$\frac{\text{Amount of bonus attributable to timber held for six months or less}}{\text{Total bonus}} \times \text{Adjusted basis for depletion of bonus} = \text{Depletion allowance on timber held for six months or less}$$

$$\frac{\$1,000}{\$5,000} \times \$4,500 = \$900$$

The amount of the bonus attributable to timber held for more than six months, and which is treated under section 631(b) as realized from the sale of timber would be \$4,000. The gain on such amount is \$400 (\$4,000-\$3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.*—(1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term "timber" includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.



§ 1.631-3 GAIN OR LOSS UPON THE DISPOSAL OF COAL WITH A RETAINED ECONOMIC INTEREST.—(a) *In general*.—(1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite) held for more than 6 months before such disposal under any form or type of contract whereby he retains an economic interest in such coal. The difference between the amount realized from disposal of such coal in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of such coal. See paragraph (b) (4) of this section for definition of “owner”.

(2) In the case of such a disposal, the provisions of section 1231 apply and such coal shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold will be deemed to be gain or loss resulting from a sale of a or business as defined in section 1231(b), regardless of whether such coal is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal which is considered to have been sold will be deemed to be gain or less resulting from a sale of a capital asset held for more than six months will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Rules for application of section*.—(1) For purposes of section 631(c) and this section, the date of disposal of such coal shall be deemed to be the date the coal is mined. If the coal has been held for more than 6 months on the date it is mined, it is immaterial that it had not been held for more than 6 months on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal under section 631(c).

(2) The term “adjusted depletion basis” as used in section 631(c) and in this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such “adjusted depletion basis” shall include exploration or development expenditures treated as deferred expenses under section 615(b) or 616 (b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016(a) (9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal disposed of shall be determined under the rules provided in the regulations under section 611 relating to cost depletion.

(3) (i) In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties (except rents and royalties paid by a lessee with respect to coal disposed of by the lessee as an “owner” under section 631 (c)) shall be determined without regard to the provisions of section 631(c). Thus, the amounts of rents and royalties paid or incurred by a lessee with respect to coal shall be excluded from the lessee’s gross income from the property for the purpose of determining his percentage depletion without regard to the treatment of such rents or royalties in the hands of the recipient under this section. See section 613 and the regulations thereunder.

(ii) However, a lessee who is also a sublessor may dispose of coal as an "owner" under section 631(c). Rents and royalties paid with respect to coal disposed of by such a lessee under section 631(c) shall increase the adjusted depletion basis of the coal and are not otherwise deductible. For example, B is a sublessor of a coal lease; A is the lessor; and C is the sublessee. B pays A a royalty of 50 cents per ton. C pays B a royalty of 60 cents per ton. The amount realized by B under section 631(c) is 60 cents per ton and will be reduced by the adjusted depletion basis of 50 cents per ton, leaving a gain of 10 cents per ton taxable under section 631(c).

(4)(i) The provisions of this section apply only to an owner who has disposed of coal and retained an economic interest. For the purposes of section 631(c) and this section, the word "owner" means any person who owns an economic interest in coal in place, including a sublessor thereof. A person who merely acquires an economic interest and has not disposed of coal under a contract retaining an economic interest does not qualify under section 631(c). A successor to the interest of a person who has disposed of coal under a contract by virtue of which he retained an economic interest in such coal is also entitled to the benefits of this section. Such sections shall not apply with respect to any income realized by any owner as co-adventurer, partner, or principal in the mining of such coal.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* A owns a tract of coal land in fee. A leases to B the right to mine all the coal in such tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in such tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631(c) applies to the royalties of both A and B, if the other requisites of such section have been met.

*Example (2).* Assume the same facts as in example (1) except that A dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631(c) treatment with respect to his share of the royalties since he is a successor in title to A.

*Example (3).* Assume the same facts as in example (1) except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore, does not qualify under section 631(c). E is entitled to depletion on his royalties.

(c) *Payments received in advance of mining.*—(1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631(c) as received from the sale of coal if the contract of disposal provides that such amounts are to be applied as payment for coal subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal qualify under such section where the contract of disposal grants the lessee the right to apply such royalties in payment of coal mined at a later time. Thus, if A acquires

coal rights on January 1, and on January 30 enters into a contract of disposal providing that mining shall begin July 2, and mining actually begins no earlier, any advance payments which A receives qualify under section 631(c).

(2) However, if the right to mine coal under the contract expires, terminates, or is abandoned before the coal which has been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal as ordinary income and not as received from the sale of coal under section 631(c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(c) as received from the sale of coal to the extent attributable to coal held for more than six months. The rules contained in § 1.631-2(d) relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal under this section.

(d) *Nonapplication of section.*—Section 631(c) shall not affect the application of the provisions of subchapter G of chapter 1 of the Internal Revenue Code of 1954, relating to corporations used to avoid income tax on shareholders. For example, in applying the provisions of section 543(a)(8)(A), the amounts received from a disposal of coal subject to section 631(c) shall be considered as mineral royalties. For purposes of determining whether certain deductions of the taxpayer constitute 15 percent or more of gross income under section 543(a)(8)(B), the deductions disallowed under section 272 shall be considered as allowable.

#### § 1.632 STATUTORY PROVISIONS; SALE OF OIL OR GAS PROPERTIES. SEC. 632. SALE OF OIL OR GAS PROPERTIES.

In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the surtax imposed by section 1 attributable to such sale shall not exceed 30 percent of the selling price of such property or interest.

§ 1.632-1 SURTAX ON SALE OF OIL OR GAS PROPERTIES.—(a) If the taxpayer, by prospecting and locating claims or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by section 1 (see section 1(c)) attributable to a sale of such property, or of any interest of the taxpayer therein, shall not exceed 30 percent of the selling price of such property or such interest. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 632 to a particular case, the taxpayer should first compute the surtax imposed by section 1 upon his entire taxable income, including the taxable income from any sale of such property or interest therein, without regard to section 632. The proportion of the surtax, so computed, indicated by the ratio which

the taxpayer's taxable income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total taxable income is the portion of the surtax attributable to such sale and, if it exceeds 30 percent of the selling price of such property or interest, such portion of the surtax shall be reduced to that amount.

(b) In determining the portion of the taxable income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

#### ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

##### ESTATES, TRUSTS, AND BENEFICIARIES

###### MISCELLANEOUS

§ 1.681(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; LIMITATION ON CHARITABLE CONTRIBUTIONS DEDUCTION; UNRELATED BUSINESS INCOME.

#### SEC. 681. LIMITATION ON CHARITABLE DEDUCTION.

(a) TRADE OR BUSINESS INCOME.—In computing the deduction allowable under section 642(c) to a trust, no amount otherwise allowable under section 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year. For purposes of the preceding sentence, the term "unrelated business income" means an amount equal to the amount which, if such trust were exempt from tax under section 501(a) by reasons of section 501(c)(3), would be computed as its unrelated business taxable income under section 512 (relating to income derived from certain business activities and from certain leases).

§ 1.681(a)-1 LIMITATIONS ON CHARITABLE CONTRIBUTIONS DEDUCTION OF TRUSTS; SCOPE OF SECTION 681.—Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1)(A) and (B), under the following circumstances:

(a) To the extent that the deduction is allocable to "unrelated business income";

(b) If the trust has engaged in a "prohibited transaction";

(c) If income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid

out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681 (a)-2 through 1.681 (c)-1. For definition of the term "income" see section 643(b) and § 1.643 (b)-1.

§ 1.681(a)-2 LIMITATION OF CHARITABLE CONTRIBUTIONS DEDUCTION OF TRUSTS WITH TRADE OR BUSINESS INCOME.—(a) *In general.* No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681(a) the term "unrelated business income" of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term "unrelated trade or business" includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to "unrelated business income", a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1)(A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) *Determination of amounts allowable to unrelated business income.*—In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501 (a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust,

determined without the deduction for personal exemption under section 642 (b), the charitable contributions deduction under section 642 (c), or the deduction for distributions to beneficiaries under section 661 (a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b) (11) if the trust were an organization exempt from tax under section 501 (a) by reason of section 501 (c) (3).

(c) *Examples.*—(1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a church, an educational organization, or a hospital described in section 170 (b) (1) (A) (see subparagraph (2) of this paragraph):

*Example (1).* The X trust has income of \$50,000. There is included in this amount a net profit of \$31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c) (2). The trustee pays each beneficiary \$25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b) (11)) is \$30,000 (\$31,000 less the deduction of \$1,000 allowed by section 512(b) (12)). The deduction otherwise allowable under section 642(c) is \$25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b) (2) of this section) is \$15,000, that is, an amount which bears the same ratio to \$25,000 as \$30,000 bears to \$50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is \$15,000 reduced by \$6,000 (20 percent of \$30,000, the charitable contributions deduction which would be allowable under section 512(b) (11), or \$9,000.

*Example (2).* Assume the same facts as in example (1), except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays \$40,000 to A and \$10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is \$10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b) (2) of this section is \$6,000, that is, an amount which bears the same ratio to \$10,000 as \$30,000 bears to \$50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b) (11) (\$6,000, determined as in example (1)), no portion of it is disallowed as a deduction.

*Example (3).* Assume the same facts as in example (1), except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays \$31,000 to the Y charity and \$19,000 to A. The deduction otherwise allowable under section 642(c) is \$31,000.

out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681 (a)—2 through 1.681 (c)—1. For definition of the term “income” see section 643(b) and § 1.643 (b)—1.

§ 1.681(a)—2 LIMITATION OF CHARITABLE CONTRIBUTIONS DEDUCTION OF TRUSTS WITH TRADE OR BUSINESS INCOME.—(a) *In general.* No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681(a) the term “unrelated business income” of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term “unrelated trade or business” includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to “unrelated business income”, a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1) (A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) *Determination of amounts allowable to unrelated business income.*—In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501 (a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust,

determined without the deduction for personal exemption under section 642 (b), the charitable contributions deduction under section 642 (c), or the deduction for distributions to beneficiaries under section 661 (a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b) (11) if the trust were an organization exempt from tax under section 501 (a) by reason of section 501 (c) (3).

(c) *Examples.*—(1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a church, an educational organization, or a hospital described in section 170 (b) (1) (A) (see subparagraph (2) of this paragraph):

*Example (1).* The X trust has income of \$50,000. There is included in this amount a net profit of \$31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c) (2). The trustee pays each beneficiary \$25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b) (11)) is \$30,000 (\$31,000 less the deduction of \$1,000 allowed by section 512(b) (12)). The deduction otherwise allowable under section 642(c) is \$25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b) (2) of this section) is \$15,000, that is, an amount which bears the same ratio to \$25,000 as \$30,000 bears to \$50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is \$15,000 reduced by \$6,000 (20 percent of \$30,000, the charitable contributions deduction which would be allowable under section 512(b) (11), or \$9,000.

*Example (2).* Assume the same facts as in example (1), except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays \$40,000 to A and \$10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is \$10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b) (2) of this section is \$6,000, that is, an amount which bears the same ratio to \$10,000 as \$30,000 bears to \$50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b) (11) (\$6,000, determined as in example (1)), no portion of it is disallowed as a deduction.

*Example (3).* Assume the same facts as in example (1), except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays \$31,000 to the Y charity and \$19,000 to A. The deduction otherwise allowable under section 642(c) is \$31,000.



Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512(b)(11) is \$30,000 (\$31,000 less the deduction of \$1,000 allowed by section 512(b)(12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is \$24,000 (\$30,000 less \$6,000).

*Example (4).* (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of \$50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of \$50,000 includes \$10,000 capital gains, \$30,000 (\$31,000 less the \$1,000 deduction allowed under section 512(b)(12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) and other income of \$9,000. The trustee pays each beneficiary \$20,000.

(ii) The deduction otherwise allowable under section 642(c) is \$30,000 (\$20,000 paid to Y charity and \$10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is \$15,000, that is, an amount which bears the same ratio to \$20,000 (the amount paid to Y charity) as \$30,000 bears to \$40,000 (\$50,000 less \$10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is \$15,000 reduced by \$6,000 (the charitable contributions deduction which would be allowable under section 512(b)(11)), or \$9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a church, an educational organization, or a hospital described in section 170(b)(1)(A), then the deduction allowable under section 512(b)(11) would be computed at a rate of 30 percent.

#### § 1.681(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS; LIMITATION ON CHARITABLE CONTRIBUTIONS DEDUCTION; PROHIBITED TRANSACTIONS.

#### SEC. 681. LIMITATIONS ON CHARITABLE DEDUCTION. \* \* \*

##### (b) OPERATIONS OF TRUSTS.—

(1) LIMITATION ON CHARITABLE, ETC., DEDUCTION.—The amount otherwise allowable under section 642(c) as a deduction shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)) if the trust has engaged in a prohibited transaction, as defined in paragraph (2).

(2) PROHIBITED TRANSACTIONS.—For purposes of this subsection, the term "prohibited transaction" means any transaction after July 1, 1950, in which any trust while holding income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes described in section 642(c)—

(A) lends any part of such income or corpus, without receipt of adequate security and a reasonable rate of interest, to;

(B) pays any compensation from such income or corpus, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

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(C) makes any part of its services available on a preferential basis to;

(D) uses such income or corpus to make any substantial purchase of securities or any other property, for more than an adequate consideration in money or money's worth, from;

(E) sells any substantial part of the securities or other property comprising such income or corpus, for less than an adequate consideration in money or money's worth, to; or

(F) engages in any other transaction which results in a substantial diversion of such income or corpus to;

the creator of such trust; any person who has made a substantial contribution to such trust; a member of a family (as defined in section 267(c) (4)) of an individual who is the creator of the trust or who has made a substantial contribution to the trust; or a corporation controlled by any such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(3) TAXABLE YEARS AFFECTED.—The amount otherwise allowable under section 642(c) as a deduction shall be limited as provided in paragraph (1) only for taxable years after the taxable year during which the trust is notified by the Secretary that it has engaged in such transaction, unless such trust entered into such prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642(c), and such transaction involved a substantial part of such corpus or income.

(4) FUTURE CHARITABLE, ETC., DEDUCTIONS OF TRUSTS DENIED DEDUCTION UNDER PARAGRAPH (3).—If the deduction of any trust under section 642(c) has been limited as provided in this subsection, such trust, with respect to any taxable year following the taxable year in which notice is received of limitation of deduction under section 642(c), may, under regulations prescribed by the Secretary or his delegate, file claim for the allowance of the unlimited deduction under section 642(c), and if the Secretary, pursuant to such regulations, is satisfied that such trust will not knowingly again engage in a prohibited transaction, the limitation provided in paragraph (1) shall not apply with respect to taxable years after the year in which such claim is filed.

(5) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.—No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 170, 545(b) (2), 642(c), 2055, 2106(a) (2), or 2522, shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or bequest is made, the deduction allowed the trust under section 642(c) is limited by paragraph (1). With respect to any taxable year of a trust in which such deduction has been so limited by reason of entering into a prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642(c), and such transaction involved a substantial part of such income or corpus, and which taxable year is the same, or before the, taxable year of the trust in which such prohibited transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 267(c) (4)) was a party to such prohibited transaction.

(6) DEFINITION.—For purposes of this subsection, the term "gift or bequest" means any gift, contribution, bequest, devise, or legacy, or any transfer without adequate consideration.

§ 1.681(b)-1 LIMITATION ON CHARITABLE CONTRIBUTIONS DEDUCTION OF TRUSTS ENGAGED IN PROHIBITED TRANSACTIONS.—(a) *In general.*—(1) If a trust has engaged in a "prohibited transaction", the charitable contributions deduction which would otherwise be allowable to the trust under section 642 (c) is limited by section 681(b)(1) to

20 percent of the taxable income of the trust (computed without any charitable contributions deduction), except that an additional deduction of up to 10 percent of such taxable income is allowed for amounts actually paid to a church, an educational organization, or a hospital qualifying under section 170(b)(1)(A). There is no requirement that amounts subject to the 20-percent limitation be actually paid, if they are set aside or are to be used exclusively for charitable or other purposes so that they would be deductible under section 642(c).

(2) A "prohibited transaction" is any transaction described in section 681(b)(2)(A) through (F), entered into after July 1, 1950, by a trust holding income or corpus permanently set aside or to be used exclusively for purposes described in section 642(c), with (i) the creator of the trust, (ii) any substantial contributor to the trust, (iii) a member of the family (as defined in section 267(c)(4), dealing with transactions between related taxpayers) of the creator or of a substantial contributor, or (iv) a corporation which the creator or a substantial contributor controls (within the meaning of the last portion of section 681(b)(2)).

(3) If the trust entered into a prohibited transaction for the purpose of diverting income or corpus from the charitable or other purposes described in section 642(c), and if the transaction involved a substantial portion of such income or corpus, the limitation of section 681(b)(1) is applicable for the taxable year of the trust in which the transaction was commenced and for all subsequent taxable years. See examples under § 1.681(b)-2 and the regulations under section 503. Otherwise, the limitation is only applicable for taxable years of the trust after the taxable year in which there is mailed to it, by registered or certified mail directed to the last known address of the fiduciary, a written notice by the Commissioner that it has engaged in a prohibited transaction.

(b) *Restoration of unlimited deduction.*—A trust whose charitable contributions deduction under section 642(c) has been limited by reason of the provisions of section 681(b)(1) may file, in any taxable year following the taxable year in which notice of limitation of the deduction was issued, a claim for allowance of an unlimited deduction under section 642(c). This claim shall be filed with the district director with whom the fiduciary is required to file the income tax return of the trust. The claim must contain or have attached to it a written declaration made under the penalties of perjury by the fiduciary (or fiduciaries) that he will not knowingly permit the trust again to engage in a prohibited transaction. If the district director is satisfied that the trust will not knowingly again engage in a prohibited transaction, he shall so notify the trust in writing. In such case the trust will be allowed an unlimited deduction under section 642(c) (subject to the provisions of section 681) with respect to taxable years subsequent to the taxable year in which the claim is filed. Section 681(b)(3) contemplates that a trust whose charitable contributions deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

§ 1.681(b)-2 DISALLOWANCE TO DONORS OF CERTAIN CHARITABLE, ETC., DEDUCTIONS FOR GIFTS MADE IN TRUST.—(a) *In general.*—Section 681(b) (5) provides that no contribution which would otherwise be allowable as a deduction under section 170(c) (2), 545(b) (2), or 642(c) is allowable if made to a trust whose charitable contribution deduction under section 642(c) is limited, in the taxable year of the trust in which the contribution is made, under the provisions of section 681(b) (1) by reason of a prohibited transaction. However, this disallowance is applicable only to contributions made in taxable years of the trust after the taxable year in which occurred the prohibited transaction causing the trust's charitable deduction to be limited, unless—

(1) The trust has been notified in a previous taxable year (in or subsequent to the year in which the transaction was commenced) by the Commissioner, pursuant to section 681(b) (3), that it has engaged in a prohibited transaction, or

(2) The donor of the contribution or, if the donor is an individual, any member of his family (as defined in section 267(c) (4), dealing with transactions between related taxpayers) was a party to the prohibited transaction.

(b) *Subsection not exclusive.*—The prohibited transactions enumerated in section 681(b) (2) are in addition to and not in limitation of the restrictions contained in section 170(c) (2), 545(b) (2), or 642(c). A deduction may not be allowed in view of the general provisions of those sections, even though the trust has not engaged in any of the prohibited transactions referred to in section 681(b) (2). Thus, if the donor or the fiduciary of the trust enters into a transaction with the trust, the transaction will be closely scrutinized to ascertain whether the contribution is in fact made for the stated exempt purposes.

(c) *Example.*—Under the terms of an irrevocable trust established by A in 1954, the trustees were to pay half of the income of the trust to A's wife for life, and the trustees were given discretion either to accumulate the remaining half of the income for, or distribute it to, a specified charitable beneficiary. Upon the death of the wife, the entire corpus was to be paid to the named charity. The trust makes its income tax returns on the basis of the calendar year. For 1954, A takes a charitable contributions deduction for the amount of the gift in trust to the charity. In 1957, 1958, 1959, and 1960, A makes further contributions to the trust and he takes deductions for those years under section 170(c) (2). In 1958, 1959, and 1960, B (not a member of A's family) also makes contributions to the trust for its designated charitable purpose and he takes deductions for those years. In 1958, the trust commences purposely to divert to A, the creator of the trust, income and corpus which had been set aside for its charitable purpose and a substantial amount of income and corpus is so diverted by the close of the year 1959. For 1958 and subsequent years, the deduction allowed the trust under section 642(c) is limited by reason of the provisions of section 681(b) (1). Both A and B are disallowed any deduction for their charitable contributions made during 1960 to the trust. Moreover,

the deductions taken by A for contributions to the trust in the years 1958 and 1959 would also be disallowed since A was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1957 by A was for the purpose of the prohibited transaction, then A's charitable contribution deduction for the year 1957 is also disallowed since the prohibited transaction would then have commenced with the making of the contribution and the deduction allowed the trust under section 642(c) would then be limited for 1957 by reason of the provisions of section 681(b)(1). The deductions taken by B for 1958 and 1959 are allowed.

§ 1.681(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS; LIMITATION ON CHARITABLE CONTRIBUTIONS DEDUCTION; TRUSTS ACCUMULATING INCOME.

SEC. 681. LIMITATION ON CHARITABLE DEDUCTION. \* \* \*

(c) ACCUMULATED INCOME.—If the amounts permanently set aside, or to be used exclusively for the charitable and other purposes described in section 642(c) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out such purposes of the trust;

(2) are used to a substantial degree for purposes other than those prescribed in section 642(c); or

(3) are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries.

the amount otherwise allowable under section 642(c) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)). Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

§ 1.681(c)-1 LIMITATION ON CHARITABLE CONTRIBUTIONS DEDUCTION OF TRUSTS ACCUMULATING INCOME.—(a) *In general*.—If income of a trust permanently set aside or to be used by a trust exclusively for charitable or other purposes described in section 642(c) during the taxable year or any prior taxable year (including taxable years beginning before the effective date of section 681), is not actually paid out by the end of the taxable year, the charitable contributions deduction which would otherwise be allowable to the trust under section 642(c) for the taxable year is subject to the limitations of section 681(c), described in paragraph (b) of this section, under the following circumstances:

(1) If accumulations of income are unreasonable. (See paragraph (c) of this section.)

(2) If income accumulated for the charitable or other purposes is used to a substantial degree for purposes other than those described in section 642(c).

(3) If income accumulated for the charitable or other purposes

is invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries. Whether the foregoing conditions are present in any case must be determined from all relevant facts. Such conditions may result from the use of a chain of two or more organizations, as well as from the use of only one trust. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust is subject to the provisions of section 681(c).

(b) *Extent of limitation.*—If a trust is subject to the limitations of section 681(c) for any taxable year, the charitable deduction which would otherwise be allowable to the trust under section 642(c) is limited to amounts actually paid out during the taxable year, and is limited to 20 percent of the taxable income of the trust (computed without any charitable deduction), except that an additional deduction of up to 10 percent of such taxable income is allowed for amounts actually paid to a church, an educational organization, or a hospital qualifying under section 170(b)(1)(A).

(c) *Unreasonable accumulations.*—Accumulations of income for a charitable or other purpose described in section 642(c) are unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed, in order to carry out the charitable or other purpose for which the income was set aside. If the gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, is not within a reasonable time reinvested in property acquired and held in good faith for the production of investment income, the gain (except the gain upon the sale or exchange of a donated asset to the extent that the gain represents the excess of the fair market value of the asset when acquired by the trust over its substituted basis in the hands of the trust) will be considered income for the purposes of this section. The limitation of section 681(c)(1) upon trusts unreasonably accumulating income does not apply to a testamentary trust created by a decedent dying before January 1, 1951, except to the extent that its income is attributable to property transferred to the trust by someone other than the decedent. Further, the limitation of section 681(c)(1) does not apply to income accumulated pursuant to the mandatory terms of testamentary trusts created by decedents dying on or after January 1, 1951, except as to income accumulated during a taxable year beginning more than 21 years after the death of the last life in being designated in the trust instrument.

(d) *Restoration of unlimited deduction.*—A trust whose charitable contributions deduction under section 642(c) has been limited by reason of the provisions of section 681(c) may file a claim for allowance of unlimited deduction under section 642(c). This claim shall be filed with the district director with whom the fiduciary is required to file the income tax return of the trust. The claim must contain or be accompanied by information or evidence showing that the circumstances that brought about the application of section 681(c) no longer exist, and a written declaration made under the penalties of perjury by the fiduciary (or fiduciaries) that he will not knowingly permit the trust again to violate the terms of such section.

contemplates that a trust whose charitable, etc., deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

§ 1.681(d) STATUTORY PROVISIONS; ESTATES AND TRUSTS; DISALLOWANCE OF CERTAIN CHARITABLE CONTRIBUTIONS DEDUCTIONS; CROSS REFERENCE.

SEC. 681. LIMITATION ON CHARITABLE DEDUCTION. \* \* \*

(d) CROSS REFERENCE.—For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see section 503(e).

§ 1.681(d)-1 DISALLOWANCE OF CERTAIN CHARITABLE CONTRIBUTIONS DEDUCTIONS.—For disallowance of certain charitable contributions deductions otherwise allowable under section 642(c), see section 503(e) and the regulations thereunder.

§ 1.682(a) STATUTORY PROVISIONS; ESTATE AND TRUSTS; INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE; INCLUSION IN GROSS INCOME OF WIFE.

SEC. 682. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC.

(a) INCLUSION IN GROSS INCOME OF WIFE.—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

§ 1.682(a)-1 INCOME OF TRUST IN CASE OF DIVORCE, ETC.—(a) *In general.*—(1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in § 1.682(b)-1 be referred to as the "wife" and the obligor spouse from whom she is divorced or legally separated as the "husband." (See section 7701(a) (17).) Thus, under section 682(a) income of a trust—

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

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(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband, is includible in her gross income and is not includible in his gross income.

(2) Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under sections 641 through 668.

(3) Section 682(a) is designed to produce uniformity as between cases in which, without section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682(a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

*Example (1).* Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

*Example (2).* H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property



in the value of \$100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers \$100,000 of property to W, the \$100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children*.—Section 682(a) does not require the inclusion in the wife's income of trust income which the terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See § 1.71-1.

§ 1.682(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS; INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE; WIFE CONSIDERED A BENEFICIARY.

SEC. 682. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC. \* \* \*

(b) WIFE CONSIDERED A BENEFICIARY.—For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) or section 71 applies, such wife shall be considered as the beneficiary specified in this part. A periodic payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

§ 1.682(b)-1 APPLICATION OF TRUST RULES TO ALIMONY PAYMENTS.—(a) For the purpose of the application of section 641 to 668, inclusive, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations.

(b) A periodic payment includible in the wife's gross income under section 71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of \$5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the \$5,000 distributable on December 31, 1954, \$4,000 is payable out of income and \$1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in

1955, since under section 662 the \$4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the \$1,000 payment out of corpus is also to be included in her income for 1954.

§ 1.682(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS; INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE; DEFINITIONS "HUSBAND" AND "WIFE".

SEC. 682. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC. \* \* \*

(c) CROSS REFERENCE.—For definitions of "husband" and "wife", as used in this section, see section 7701(a) (17).

§ 1.682(c)-1 DEFINITIONS.—For definitions of the term "husband" and "wife" as used in section 682, see section 7701(a) (17) and the regulations thereunder.

#### INCOME IN RESPECT OF DECEDENTS

§ 1.691(a) STATUTORY PROVISIONS; RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS; INCLUSION IN GROSS INCOME.

SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS.

(a) INCLUSION IN GROSS INCOME.—

(1) GENERAL RULE.—The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

(2) INCOME IN CASE OF SALE, ETC.—If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

(3) CHARACTER OF INCOME DETERMINED BY REFERENCE TO DECEDENT.—The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross

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income under paragraph (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

(4) **INSTALLMENT OBLIGATIONS ACQUIRED FROM DECEDENT.**—In the case of an installment obligation received by a decedent on the sale or other disposition of property, the income from which was properly reportable by the decedent on the installment basis under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent—

(A) an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453(d)) shall, for the purpose of paragraph (1), be considered as an item of gross income in respect of the decedent; and

(B) such obligation shall, for purposes of paragraphs (2) and (3), be considered a right to receive an item of gross income in respect of the decedent, but the amount includible in gross income under paragraph (2) shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)).

§ 1.691(a)-1 **INCOME IN RESPECT OF A DECEDENT.**—(a) *Scope of section 691.*—In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute "income in respect of a decedent"; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credits in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; and (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract.

(b) *General definition.*—In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes—

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

See sections 736 and 753 and the regulations thereunder for "income in respect of a decedent" in the case of a deceased partner.

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(c) *Prior decedent.*—The term “income in respect of a decedent” also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent’s taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example (2) of paragraph (b) of § 1.691(a)–2.

(d) *Items excluded from income.*—Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Internal Revenue Code of 1954 are not within the provisions of section 691.

(e) *Cross reference.*—For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691(c), see paragraph (c) of § 1.691(c)–1.

§ 1.691(a)–2 INCLUSION IN GROSS INCOME BY RECIPIENTS.—(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of—

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent’s estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent’s estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent’s estate of such right. These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements method.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method:

*Example (1).* The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

*Example (2).* A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow’s gross income but must be included in the gross income of the son.

*Example (3).* The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

*Example (4).* A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of \$100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for \$500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

*Example (5).* (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had an interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

§ 1.691(a)-3 CHARACTER OF GROSS INCOME.—(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent

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(or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

(b) The application of paragraph (a) of this section may be illustrated by the following:

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property held for more than 6 months, the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 6 months, in the same manner as if such person had held the property for the period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under sections 1301 to 1305, inclusive, relating to income attributable to several taxable years, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

§ 1.691(a)-4 TRANSFER OF RIGHT TO INCOME IN RESPECT OF A DECEDENT.—(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see § 1.691(a)-5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when re-

ceived in his gross income. In this situation, a transfer within the meaning of section 691(a)(2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred from an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received.

If the transferee described in subparagraph (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

§ 1.691(a)-5 INSTALLMENT OBLIGATIONS ACQUIRED FROM DECEDENT.—(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest, devise, or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691(a)(2) and paragraph (a) of § 1.691(a)-4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross in-

come of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term "transfer" in section 691(a)(2) and paragraph (a) of § 1.691(a)-4 includes the satisfaction of an installment obligation at other than face value.

(c) The application of this section may be illustrated by the following example:

*Example.* An heir of a decedent is entitled to collect an installment obligation with a face value of \$100, a fair market value of \$80, and a basis in the hands of the decedent of \$60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691(a)(1). In this case, the amount includible would be \$40 (\$100 less \$60). If the heir collects the obligation at \$90, an amount other than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691(a)(2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be \$30 (\$90 less \$60).

## § 1.691(b) STATUTORY PROVISIONS; RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS; ALLOWANCE OF DEDUCTIONS AND CREDIT.

### SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS. \* \* \*

(b) ALLOWANCE OF DEDUCTIONS AND CREDIT.—The amount of any deduction specified in section 162, 163, 164, 212, or 611 (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 33 (relating to foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

(1) EXPENSES, INTEREST, AND TAXES.—In the case of a deduction specified in section 162, 163, 164, or 212 and a credit specified in section 33, in the taxable year when paid—

(A) to the estate of the decedent; except that

(B) if the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, to the person who, by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.

(2) DEPLETION.—In the case of the deduction specified in section 611, to the person described in subsection (a)(1)(A), (B), or (C) who, in the manner described therein, receives the income to which the deduction relates, in the taxable year when such income is received.

§ 1.691(b)-1 ALLOWANCE OF DEDUCTIONS AND CREDIT IN RESPECT OF DECEDENTS.—(a) Under section 691(b), the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid—

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- (1) As a deduction by the estate; or
- (2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent (or the prior decedent).

Similar treatment is given to the foreign tax credit provided by section 33. For the purposes of subparagraph (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to an income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691(a)(1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 1.691(c) STATUTORY PROVISIONS; RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS; DEDUCTION FOR ESTATE TAX.

SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS. \* \* \*

(c) DEDUCTION FOR ESTATE TAX.—

(1) ALLOWANCE OF DEDUCTION.—

(A) GENERAL RULE.—A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a)(1) as the value for estate tax

purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a) (1).

(B) ESTATES AND TRUSTS.—In the case of an estate or trust, the amount allowed as a deduction under subparagraph (A) shall be computed by excluding from the gross income of the estate or trust the portion (if any) of the items described in subsection (a) (1) which is properly paid, credited, or to be distributed to the beneficiaries during the taxable year. This subparagraph shall apply to the same taxable year, and to the same extent, as is provided in section 683.

(2) METHOD OF COMPUTING DEDUCTION.—For purposes of paragraph (1)—

(A) The term “estate tax” means the tax imposed on the estate of the decedent or any prior decedent under section 2001 or 2101, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a) (1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a) (1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with regard to the provisions of section 421(d) (6) (B), relating to the deduction for estate tax with respect to restricted stock options.

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

§ 1.691(c)–1 DEDUCTION FOR ESTATE TAX ATTRIBUTABLE TO INCOME IN RESPECT OF A DECEDENT.—(a) *In general*.—A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent’s estate which is attributable to the inclusion in the decedent’s estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent’s estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see § 1.691(a)–1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see § 1.691(b)–1). But see section 691(d) and paragraph (b) of § 1.691(d)–1 for computation of the special value of a survivor’s annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value. This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example (2), paragraph (e) of § 1.691(d)–1.

For purposes of this section, the term “estate tax” means the tax imposed under section 2001 or 2101 (or the corresponding provisions

of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) *Prior decedent.*—If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) *Amounts deemed to be income in respect of a decedent.*—For purposes of allowing the deduction under section 691(c), the following items are also considered to be income in respect of a decedent under section 691(a):

(1) The value for estate tax purposes of restricted stock options in respect of which amounts are includible in gross income under section 421(b). See section 421(d)(6).

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691(d).

(d) *Examples.*—Paragraphs (a) and (b) of this section may be illustrated by the following examples:

*Example (1).* X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at \$1,000, and to accrued bond interest, which was valued in his estate at \$500. In all, \$1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate \$150 for business expenses for which his estate was liable and \$50 for taxes accrued on certain property which he owned. In all, \$200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was \$185,000 and, considering deductions of \$15,000 and an exemption of \$60,000, his taxable estate amounted to \$110,000. The estate tax on this amount is \$23,700 from which is subtracted a \$75 credit for State death taxes leaving an estate tax liability of \$23,625. In the year following the closing of X's estate, the fee in the amount of \$1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year,

\$260 on account of the estate tax attributable to such income, computed as follows:

(1)	(i)	Value of income described in section 691(a) (1) including in computing gross estate .....	\$1,500
	(ii)	Deductions in computing gross estate for claims representing deductions described in section 691(b) .....	290
	(iii)	Net value of items described in section 691(a) (1) .....	\$1,210
(2)	(i)	Estate tax .....	\$180.15
	(ii)	Less: Estate tax computed without including \$1,500 (item (1) (iii)) in gross estate .....	154.15
	(iii)	Portion of estate tax attributable to net value of items described in section 691(a) (1) .....	\$260
(3)	(i)	Value in gross estate of items described in section 691(a) (1) received in taxable year (fee) .....	\$1,000
	(ii)	Value in gross estate of all income items described in section 691(a) (1) (item (1) (i)) .....	1,500
	(iii)	Part of estate tax deductible on account of receipt of \$1,200 fee (1,000/1,500 of \$390) .....	290

Although \$1,200 was later collected as the fee, only the \$1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only \$500, the estate tax deductible on the receipt of such amount would be 500/1,500 of \$390, or \$130. See paragraph (d) (3) of § 1.421-5 for a similar example involving a restricted stock option.

*Example (2).* Assume that in example (1) the fee valued at \$1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at \$1,000 in Y's estate, that the net value in Y's estate of items described in section 691(a) (1) was \$5,000 and that the estate tax imposed on Y's estate attributable to such net value was \$550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of \$550, or \$110. When the son collects the \$1,200 fee, he will receive for the same taxable year a deduction of \$110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of \$260 as computed in example (1) with respect to the estate tax imposed on the estate of decedent X.

§ 1.691(c)-2 ESTATES AND TRUSTS.—(a) In the case of an estate or trust, the deduction prescribed in section 691(c) is determined in the same manner as described in § 1.691(c)-1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year—

(i) Such income shall be excluded in determining the income in

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respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691(c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691(c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and §§ 1.652(b)-2 and 1.662(b)-2. However, for this purpose, distributable net income as defined in section 643(a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691(c) and this section. Distributable net income as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J of chapter 1 of the Internal Revenue Code of 1954, such as the deduction provided by section 651 or 661, or subpart D of part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691(c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691(c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691(c) (1) (B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

*Example.* (1) The fiduciary of an estate receives taxable interest of \$5,500 and income in respect of a decedent of \$4,500 during the taxable year. Neither the will of the decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is \$1,500. In his discretion, the fiduciary distributes \$2,000 (falling within sections 661(a) and 662(a)) to a beneficiary during that year. On these

facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of \$1,200 and \$300, computed as follows:

(2) Distributable net income computed under section 643(a) without regard to the estate tax deduction under section 691(c) is \$10,000, computed as follows:

Taxable interest .....	\$5,500
Income in respect of a decedent.....	4,500
Total .....	\$10,000

(3) Inasmuch as the distributable net income of \$10,000 exceeds the amount of \$2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661(a), and the amount taxable to the beneficiary under section 662(a), is \$2,000.

(4) The character of the amounts distributed to the beneficiary under section 662(b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income .....	\$5,500	\$4,500	\$10,000
Amount deemed distributed under section 662(b) ..	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of \$300 ( $900/4,500 \times \$1,500$ ) and the estate will be entitled to an estate tax deduction of \$1,200 ( $3,600 \times \$1,500$ ).

(6) The taxable income of the estate is \$6,200, computed as follows:

Gross income .....	\$10,000
Less:	
Distributions to the beneficiary .....	\$2,000
Estate tax deduction under section 691(c) .....	1,200
Personal exemption .....	600
Taxable income .....	\$6,200

## § 1.691(d) STATUTORY PROVISIONS; RECIPIENTS OF INCOME IN RESPECT OF DOCUMENTS; AMOUNTS RECEIVED BY SURVIVING ANNUITANT UNDER JOINT AND SURVIVOR ANNUITY CONTRACT.

### SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS.

\* \* \*

(d) AMOUNTS RECEIVED BY SURVIVING ANNUITANT UNDER JOINT AND SURVIVOR ANNUITY CONTRACT.—

(1) DEDUCTION FOR ESTATE TAX.—For purposes of computing the deduction under subsection (c) (1) (A), amounts received by a surviving annuitant—

(A) as an annuity under a joint and survivor annuity contract where the decedent annuitant died after December 31, 1953, and after the annuity starting date (as defined in section 72(c) (4)), and

(B) during the surviving annuitant's life expectancy period, shall, to the extent included in gross income under section 72, be considered as amounts included in gross income under subsection (a).

(2) NET VALUE FOR ESTATE TAX PURPOSES.—In determining the net value for estate tax purposes under subsection (c) (2) (B) for purposes of this subsection, the value for estate tax purposes of the items described in paragraph (1) of this subsection shall be computed—

(A) by determining the excess of the value of the annuity at the date of the death of the deceased annuitant over the total amount

excludable from the gross income of the surviving annuitant under section 72 during the surviving annuitant's life expectancy period, and

(B) by multiplying the figure so obtained by the ratio which the value of the annuity for estate tax purposes bears to the value of the annuity at the date of the death of the deceased.

(3) DEFINITIONS.—For purposes of this subsection—

(A) the term "life expectancy period" means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant. For purposes of this subparagraph, the life expectancy of the surviving annuitant shall be determined, as of the date of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) the surviving annuitant's expected return under the contract shall be computed, as of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

§ 1.691(d)-1 AMOUNTS RECEIVED BY SURVIVING ANNUITANT UNDER JOINT AND SURVIVOR ANNUITY CONTRACT.—(a) *In general*.—Under section 691(d), annuity payments received by a surviving annuitant under a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section 691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72(c)(4).

(b) *Special value for surviving annuitant's payments*.—Section 691(d) provides a special value for the surviving annuitant's payments to determine the amount of the estate tax deduction provided for in section 691(c)(1)(A). This special value is determined by multiplying—

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d)(1)(i) of this section)

by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant.

This special value is used for the purpose of determining the net value for estate tax purposes (see section 691(c)(2)(B) and paragraph (a)(1) of § 1.691(c)-1) and for the purpose of determining the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)-1).

(c) *Amount of deduction*.—The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)-1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691(d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

§ 1.691(d)-1(a)

(d) *Definitions*.—(1) For purposes of section 691(d) and this section—

(i) The term “life expectancy period” means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in § 1.72-9 (but without making any adjustment under paragraph (a) (2) of § 1.72-5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor’s annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includible in the deceased annuitant’s gross estate.

(2) The determination of the “life expectancy period” of the survivor for purposes of section 691(d) may be illustrated by the following example:

*Example.* H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W’s life expectancy determined as of the date of H’s death is 15 years as determined from Table I in § 1.72-9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691(d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15½ years.

(e) *Examples*.—The application of section 691(d) and this section may be illustrated by the following examples:

*Example (1).* (1) H and W, husband and wife, purchased a joint and survivor annuity contract for \$203,800 providing for monthly payments of \$1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed \$152,850 and W contributed \$50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H’s age at his nearest birthday was 70 and W’s age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on January 28, 1957, W receives her monthly payments of \$1,000. The value of the annuity at the date of H’s death is \$159,000 (see paragraph (d) (1) (iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d) (1) (iv) of this section) is \$119,250 (\$152,850/203,800 of \$159,000). As of the date of H’s death, W’s age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of

§ 1.691(d)-1(e)



section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year ( $12 \times \$1,000$ ) .....	\$12,000
Life expectancy of H and W as of the annuity starting date (see section 72(c)(3)(A) and Table II of § 1.72-9 (male, age 70; female, age 67)) .....	19.7
Expected return as of the annuity starting date, January 1, 1954 ( $\$12,000 \times 19.7$ as determined under section 72(c)(3)(A) and paragraph (b) of § 1.72-5) .....	236,400
Investment in the contract as of the annuity starting date, January 1, 1954 (see section 72(c)(1) and paragraph (a) of § 1.72-6) .....	203,800
Exclusion ratio ( $203,800/236,400$ as determined under section 72(b) and § 1.72-4) (percent) .....	86.2
Exclusion per year under section 72 ( $\$12,000 \times 86.2$ percent) .....	10,344
Excludable during W's life expectancy period ( $\$10,344 \times 15$ ) .....	155,160

(3) For the purpose of computing the deduction for estate tax under section 691(c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691(d)(1) is \$2,880. This amount is arrived at in accordance with the formula contained in section 691(d)(2), as follows:

Value of annuity at date of H's death .....	\$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example) .....	155,160
Excess .....	<u>\$3,840</u>
Ratio which value of annuity for estate tax purposes bear to value of annuity at date of H's death ( $119,250/159,000$ ) (percent) .....	75
Value for estate tax purposes (75 percent of \$3,840) .....	<u>\$2,880</u>

This amount (\$2,880) is included in the items of income under section 691(a)(1) for the purpose of determining the estate tax attributable to each item under section 691(c)(1)(A). The estate tax determined to be attributable to the item of \$2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example (2) of this paragraph).

*Example (2).* Assume, in addition to the facts contained in example (1) of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at \$1,000, and to accrued bond interest, which was valued at \$500. Taking into consideration the annuity payments of example (1), valued at \$2,880, a total of \$4,380 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate \$280 for business expenses for which his estate was liable and \$100 for taxes accrued on certain property which he owned. In all, \$380 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was \$404,250 and considering deductions of \$15,000, a marital deduction of \$119,250 (assuming the annuity to be the only qualifying gift) and an exemption of \$60,000, his taxable estate amounted to \$210,000. The estate tax on this amount is \$53,700

from which is subtracted a \$175 credit for State death taxes, leaving an estate tax liability of \$53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period, \$14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1)	(i)	Value of income described in section 691(a)(1) included in computing gross estate.....	\$4,380.00
	(ii)	Deductions in computing gross estate for claims representing deductions described in section 691(b).....	380.00
	(iii)	Net value of items described in section 691(a)(1)....	<u>\$4,000.00</u>
(2)	(i)	Estate tax .....	\$53,525.00
	(ii)	Less: Estate tax computed without including \$4,000 (item (1)(iii)) in gross estate and by reducing marital deduction by \$2,880 (portion of item (1)(iii) allowed as a marital deduction).....	<u>53,189.00</u>
	(iii)	Portion of estate tax attributable to net value of income items .....	<u>\$336.00</u>
(3)	(i)	Value in gross estate of income attributable to annuity payments .....	\$2,880.00
	(ii)	Value in gross estate of all income items described in section 691(a)(1) (item (1)(i)) .....	4,380.00
	(iii)	Part of estate tax attributable to annuity income (2,880/4,380 of \$336) .....	220.93
	(iv)	Deduction each year on account of estate tax attributable to annuity income ( $\$220.93 \div 15$ (life expectancy period)), .....	<u>14.73</u>

## § 1.691(e) STATUTORY PROVISIONS; RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS; CROSS REFERENCE.

### SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS. \* \* \*

(e) CROSS REFERENCE.—For application of this section to income in respect of a deceased partner, see section 753.

§ 1.691(e)-1 CROSS REFERENCES.—See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

## § 1.692 STATUTORY PROVISIONS; INCOME TAXES ON MEMBERS OF ARMED FORCES ON DEATH.

### SEC. 692. INCOME TAXES ON MEMBERS OF ARMED FORCES ON DEATH.

In the case of any individual who dies during an induction period (as defined in section 112(c)(5)) while in active service as a member of the Armed Forces of the United States, if such death occurred while serving in a combat zone (as determined under section 112) or as a result of wounds, disease, or injury incurred while so serving—

(1) any tax imposed by this subtitle shall not apply with respect to the taxable year in which falls the date of his death, or with respect to any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950; and

(2) any tax under this subtitle and under the corresponding provisions of prior revenue law for taxable years preceding those specified in paragraph (1) which is unpaid at the date of his death (including inter-

est, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

§ 1.692-1 ABATEMENT OF INCOME TAXES OF CERTAIN MEMBERS OF THE ARMED FORCES OF THE UNITED STATES UPON DEATH.—(a) If an individual dies during an induction period (as defined in section 112(c)(5)) while in active service as a member of the Armed Forces of the United States, and such death occurs while serving in a combat zone (as determined under section 112) or at any place as a result of wounds, disease, or injury incurred while so serving, then—

(1) The tax liability of such individual, under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, for the taxable year ending on the date of his death, and for any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950, is cancelled and if the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment shall be abated, and if the amount of such tax is collected (regardless of the date of collection) the amount so collected shall be credited or refunded as an overpayment; and

(2) That amount of tax of such individual for taxable years preceding those specified in subparagraph (1) of this paragraph, under subtitle A of the Internal Revenue Code of 1954, chapter 1 of the Internal Revenue Code of 1939, or corresponding provisions of prior revenue laws, which remains unpaid as of the date of death shall not be assessed, and if any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, such assessment shall be abated, and if the amount of any such unpaid tax is collected subsequent to the date of death, the amount so collected shall be credited or refunded as an overpayment.

As to what constitutes an induction period, active service as a member of the Armed Forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see section 112 and the regulations thereunder. As to who are members of the Armed Forces, see section 7701(a)(15) and the regulations thereunder.

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 692 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 112, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse—

(1) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, shall be the tax computed under subtitle A of the Internal Revenue Code of 1954 before the application of sections

31, 32, 6401(b), and 6402, but after the application of section 33, as if such spouse were required to make a separate income tax return; and

(2) For taxable years beginning before January 1, 1954, and for taxable years beginning after December 31, 1953, and ending before August 17, 1954, shall be the tax computed under chapter 1 of the Internal Revenue Code of 1939 before the application of sections 32, 35, and 322(a), but after the application of section 31, as if such spouse were required to make a separate income tax return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under chapter 24, subtitle C of the Internal Revenue Code of 1954, or under subchapter D, chapter 9 of the Internal Revenue Code of 1939 (relating to income tax withheld at source on wages), constitute payment of tax imposed under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, as the case may be.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by subtitle A of the Internal Revenue Code of 1954 or by chapter 1 of the Internal Revenue Code of 1939.

#### REGULATED INVESTMENT COMPANIES

#### § 1.851 STATUTORY PROVISIONS; DEFINITION OF REGULATED INVESTMENT COMPANY.

##### SEC. 851. DEFINITION OF REGULATED INVESTMENT COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term “regulated investment company” means any domestic corporation (other than a personal holding company as defined in section 542)—

(1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U. S. C. 80 a-1 to 80 b-2), either as a management company or as a unit investment trust, or

(2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U. S. C. 80 a-3(c)) from the definition of “investment company” and is not included in the definition of “common trust fund” by section 584(a).

(b) LIMITATIONS.—A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941;

(2) at least 90 percent of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities;

(3) less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months; and

(4) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by—

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses.

(c) RULES APPLICABLE TO SUBSECTION (b) (4).—For purposes of subsection (b) (4) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary or his delegate.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term "controlled group" means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) the taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

(4) The term "value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher.

(5) All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

(d) DETERMINATION OF STATUS.—A corporation which meets the requirements of subsections (b) (4) and (c) at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for purposes of applying the preceding sentence.

(e) INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.—

(1) GENERAL RULE.—If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the

Secretary or his delegate not less than 60 days prior to the close of the taxable year of a registered management company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b) (4) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

(2) **LIMITATION.**—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issues and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(3) **DETERMINATION OF STATUS.**—For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) **DEFINITIONS.**—The terms used in this subsection shall have the same meaning as in subsections (b) (4) and (c) of this section.

§ 1.851-1 **DEFINITION OF REGULATED INVESTMENT COMPANY.**—(a) *In general.*—The term “regulated investment company” is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirement of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851-2. As to the definition of the term “corporation”, see section 7701(a) (3).

(b) *Requirement.*—To qualify as a regulated investment company, a corporation must be—

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U. S. C.

80 a-1 to 80 b-2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 (15 U. S. C. 80 a-3(c)) from the definition of "investment company" and not included in the definition of "common trust fund" by section 584(a).

§ 1.851-2 LIMITATIONS.—(a) *Election to be a regulated investment company.*—Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of subchapter M of chapter 1 of the Internal Revenue Code of 1954 for the taxable year, will not be considered a regulated investment company for such year, within the meaning of subchapter M, unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) *Gross income requirement.*—Section 851(b)(2) and (3) provides that (1) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (2) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851(b)(2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(c) *Diversification of investments.*—(1) Subparagraph (A) of section 851(b)(4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

- (i) Cash and cash items, including receivables;
- (ii) Government securities;
- (iii) Securities of other regulated investment companies; or
- (iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: (a) The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and (b) the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851(e) and § 1.851-6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of

section 851(b)(4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851(b)(4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851(b)(4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851(b)(4).

(2) Subparagraph (B) of section 851(b)(4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851(b)(4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business.

§ 1.851-3 RULES APPLICABLE TO SECTION 851(b)(4).—In determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(4), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See example (4) in § 1.851-5. For purposes of §§ 1.851-2, 1.851-4, 1.851-5, and 1.851-6, the terms "controls", "controlled group", and "value" have the meaning assigned to them by section 851(c). All other terms used in such sections have the same meaning as when used in the Investment Company Act of 1940 (15 U. S. C., c. 2D) or that Act as amended.

§ 1.851-4 DETERMINATION OF STATUS.—With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851(b)(4) and § 1.851-2(c), or the effect that the elimination of such discrepancies, will have on the status of a company as a regulated investment company for the purposes of subchapter M of chapter 1 of the Internal Revenue Code of 1954, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or



employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 1.851-5 **EXAMPLES.**—The provisions of section 851 may be illustrated by the following examples:

*Example (1).* Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows:

	<i>Percent</i>
Cash .....	5
Government securities .....	10
Securities of regulated investment companies .....	20
Securities of Corporation A .....	10
Securities of Corporation B .....	15
Securities of Corporation C .....	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company) .....	20
<b>Total</b> .....	<b>100</b>

Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of the other corporations. None of the corporations is a member of a controlled group. Investment Company W meets the requirements under section 851(b)(4) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(4) since it has 55 percent of its assets invested as provided in such subparagraph. It complies with subparagraph (B) of section 851(b)(4) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

*Example (2).* Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	<i>Percent</i>
Cash .....	10
Government securities .....	35
Securities of Corporation A .....	7
Securities of Corporation B .....	12
Securities of Corporation C .....	15
Securities of Corporation D .....	21
<b>Total</b> .....	<b>100</b>

Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(4) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

*Example (3).* Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows:

	<i>Percent</i>
Cash and Government securities .....	20
Securities of Corporation A .....	5
Securities of Corporation B .....	10
Securities of Corporation C .....	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company) .....	40
<b>Total</b> .....	<b>100</b>

Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b) (4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

*Example (4).* Investment Company Y at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities .....	15
Securities of Corporation K (a regulated investment company) .....	30
Securities of Corporation A .....	10
Securities of Corporation B .....	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company) .....	25
Total .....	100

Corporation K has 20 percent of its assets invested in Corporation L and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation B. Investment Company Y is disqualified under subparagraph (B) of section 851(b) (4) since more than 25 percent of its assets are considered invested in Corporation B as shown by the following calculation:

Percentage of assets invested directly in Corporation B .....	20.0
Percentage invested through the controlled group, Y-K-L-B (40 percent of 20 percent of 30 percent) .....	2.4
Percentage invested in the controlled group, Y-A-B (30 percent of 10 percent) .....	3.0
Total percentage of assets of Investment Company Y invested in Corporation B .....	25.4

*Example (5).* Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1955 meets the requirements of section 851(b) (4) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1955 because of such distributions, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such distributions.

*Example (6).* Investment Company Q, which keeps its books and makes its returns on the basis of a calendar year, at the close of the first quarter of 1955, meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 1955 it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Corporation Q does not lose its status as a regulated investment company for the taxable year 1955 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such market value fluctuations.

§ 1.851-6 INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.—(a) *Qualifying requirements.*—(1) In the case of a regulated investment company which furnishes capital to development corporations, section 851(e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851(b)(4)(A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not less than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) *Exception to general rule.*—(1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851(e)(2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851(b)(4)(A) and § 1.851-2(c)(1) for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisi-

tion of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851(e)(1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851(e)(1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851(b)(4)(A)(ii) and § 1.851-2(c)(1)(iv). All other provisions and requirements of section 851 and §§ 1.851-1 through 1.851-6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* (i) The XYZ Corporation, a regulated investment company, qualified under section 851(e) as an investment company furnishing capital to development corporations. On June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of \$30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was \$1,000,000. Its investment in the stock of the A Corporation (\$30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851(b)(4)(A)(ii) as modified by section 851(e)(1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was \$1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth \$60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of \$30,000. The securities of the A Corporation owned by the XYZ Corporation had a value of \$90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851(b)(4)(A)(ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851(b)(4)(A) as modified by section 851(e)(1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954 .....	\$30,000
Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955 .....	30,000
Basis of all stock of A Corporation .....	\$60,000
Basis of stock of A Corporation .....	\$60,000
Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition.	\$1,500,000
	<hr/> = 4 percent

*Example (2).* The same facts existed as in example (1), except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of \$60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5-percent limitation provided by section 851(b) (4) (A) as modified by section 851(e) (1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954 .....	\$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955 .....	60,000
<b>Total .....</b>	<b>\$90,000</b>
Basis of stock of A Corporation .....	\$90,000
Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition.	$\frac{\$1,500,000}{\$90,000} = 6$ percent

*Example (3).* The same facts existed as in example (2) and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of \$6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was \$2,000,000 and on that date the investment in the A Corporation qualified under section 851(b) (4) (A) as modified by section 851(e) (1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954 .....	\$30,000
1,000 shares acquired June 30, 1955 .....	60,000
100 shares acquired June 30, 1956 .....	6,000
<b>Total .....</b>	<b>\$96,000</b>
Basis of stock of A Corporation .....	\$96,000
Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition.	$\frac{\$2,000,000}{\$96,000} = 4.8$ percent

(c) *Limitation.*—Section 851(e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851(b) (4) and § 1.851-2(c) (1) for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) *Definition of predecessor company.*—As used in section 851(e) and this section, the term "predecessor company" means any corporation the basis of whose securities in the hands of the investment

company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851(b) (4). See §§ 1.851-2(c) and 1.851-3.

## § 1.852 STATUTORY PROVISIONS; TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS.

### SEC. 852. TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS.

(a) REQUIREMENTS APPLICABLE TO REGULATED INVESTMENT COMPANIES.—The provisions of this subchapter shall not be applicable to a regulated investment company for a taxable year unless—

(1) the deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gains dividends) equals or exceeds 90 percent of its investment company taxable income for the taxable year (determined without regard to subsection (b) (2) (D)), and

(2) the investment company complies for such year with regulations prescribed by the Secretary or his delegate for the purpose of ascertaining the actual ownership of its outstanding stock.

(b) METHOD OF TAXATION OF COMPANIES AND SHAREHOLDERS.—

(1) IMPOSITION OF NORMAL TAX AND SURTAX ON REGULATED INVESTMENT COMPANIES.—There is hereby imposed for each taxable year upon the investment company taxable income of every regulated investment company a normal tax and surtax computed as provided in section 11, as though the investment company taxable income were the taxable income referred to in section 11. For purposes of computing the normal tax under section 11, the taxable income and the dividends paid deduction of such investment company for the taxable year (computed without regard to capital gains dividends) shall be reduced by the deduction provided by section 242 (relating to partially tax-exempt interest).

(2) INVESTMENT COMPANY TAXABLE INCOME.—The investment company taxable income shall be the taxable income of the regulated investment company adjusted as follows:

(A) There shall be excluded the excess, if any, of the net long-term capital gain over the net short-term capital loss.

(B) The net operating loss deduction provided in section 172 shall not be allowed.

(C) The deductions for corporations provided in part VIII (except section 248) in subchapter B (section 241 and following, relating to the deduction for dividends received, etc.) shall not be allowed.

(D) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends.

(E) The taxable income shall be computed without regard to section 443(b) (relating to computation of tax on change of annual accounting period).

(3) CAPITAL GAINS.—

(A) IMPOSITION OF TAX.—There is hereby imposed for each taxable year in the case of every regulated investment company a tax of 25 percent of the excess, if any, of the net long-term capital gain over the sum of—

(i) the net short-term capital loss, and

(ii) the deduction for dividends paid (as defined in section 561), determined with reference to capital gains dividends only.

(B) TREATMENT OF CAPITAL GAIN DIVIDENDS BY SHAREHOLDERS.—A capital gain dividend shall be treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 6 months.

(C) DEFINITION OF CAPITAL GAIN DIVIDEND.—A capital gain dividend means any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including capital gains dividends paid after the close of the taxable year described in section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

(c) EARNINGS AND PROFITS.—The earnings and profits of a regulated investment company for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

§ 1.852-1 TAXATION OF REGULATED INVESTMENT COMPANIES.—(a) *Requirements applicable thereto.*—Section 852(a) denies the application of the provisions of subchapter M to a regulated investment company for a taxable year unless—

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gains dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and § 1.852-3(d)); and

(2) The company complies for such taxable year with the provisions of § 1.852-6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and § 1.853-2(a) for amounts to be added to the dividend paid deduction, and section 855 and § 1.855-1, relating to dividends paid after the close of the taxable year.

(b) *Failure to qualify.*—If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a) of this section for the taxable year, it will, even though it may otherwise be classified as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of subchapter M will be applicable to it.

§ 1.852-2 METHOD OF TAXATION OF REGULATED INVESTMENT COMPANIES.—(a) *Imposition of normal tax and surtax.*—Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852-3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

§ 1.852-1(a)

(b) *Taxation of capital gains.*—Section 852(b)(3) requires that 25 percent for each taxable year on the excess. If any, of the net long-term capital gain of a regulated investment company exceeds the sum of its net short-term capital loss and its deduction for capital gains dividends (as defined in section 561) determined with regard to capital gains dividends only. For the definition of capital gain dividends paid by a regulated investment company, see section 852(b)(3)(C) and § 1.852-4(b). See section 855 and § 1.855-1 relating to capital gains paid after the close of the taxable year.

§ 1.852-3 INVESTMENT COMPANY TAXABLE INCOME.—Section 852(b)(2) requires certain adjustments to be made to a regulated investment company's taxable income to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII of subchapter B (except the deduction under section 245) shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures) is otherwise allowable in computing taxable income, shall likewise be allowed in computing the investment company taxable income. See section 852(b)(1) and § 1.852-2(a)(1) for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852(b)(3)(C) and § 1.852-4(b)); and

(e) The taxable income shall be computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

§ 1.852-4 METHOD OF TAXATION OF SHAREHOLDERS OF REGULATED INVESTMENT COMPANIES.—(a) *In general.*—(1) A shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received. Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends, in respect of the capital gains of an investment company for a taxable year for which it is taxable under subchapter M as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than six months. (2) See section 853(b)(2) and (c), and §§ 1.853-2(b) and 1.853-3, for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and



§§ 1.854-1 through 1.854-3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34, the exclusion from gross income under section 116, and the deduction under section 243. See section 855(b) and (d), and § 1.855-1(c) and (f), for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855(a).

(b) *Definition of capital gain dividend.*—A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. If the aggregate amount so designated with respect to the taxable year (including capital gain dividend shall be only that proportion of the amount suant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of \$500,000 made December 15, 1955, \$200,000 constituted a capital gain dividend, amounting to \$2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year and that such excess was \$100,000 instead of \$200,000. In such case each shareholder would have received a capital gain dividend of \$1 per share instead of \$2 per share.

§ 1.852-5 EARNINGS AND PROFITS OF A REGULATED INVESTMENT COMPANY.—In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of \$500,000 for the taxable year except for the fact that it had a net capital loss of \$100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be \$500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to \$400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, \$500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin

such year with its paid-in capital reduced by \$100,000, an amount equal to the excess of the \$500,000 distributed over the \$400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

§ 1.852-6 RECORDS TO BE KEPT FOR PURPOSE OF DETERMINING WHETHER A CORPORATION CLAIMING TO BE A REGULATED INVESTMENT COMPANY IS A PERSONAL HOLDING COMPANY.—(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by § 1.852-7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

§ 1.852-7 ADDITIONAL INFORMATION REQUIRED IN RETURNS OF SHAREHOLDERS.—Any person who fails or refuses to comply with

the demand of a regulated investment company for the written statements which § 1.852-6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferee thereof;

(d) The names and addresses of the members of his family (as defined in section 544(a) (2); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

§ 1.852-8 INFORMATION RETURNS.—Nothing in §§ 1.852-6 and 1.852-7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A of chapter 61.

## § 1.853 STATUTORY PROVISIONS; FOREIGN TAX CREDIT ALLOWED TO SHAREHOLDERS.

### SEC. 853. FOREIGN TAX CREDIT ALLOWED TO SHAREHOLDERS.

(a) GENERAL RULE.—A regulated investment company—

(1) more than 50 percent of the value (as defined in section 851(c) (4) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations, and

(2) which meets the requirements of section 852(a) for the taxable year,

may, for such taxable year, elect the application of this section with respect to income, war profits, and excess profits taxes described in section 901 (b) (1), which are paid by the investment company during such taxable year to foreign countries and possessions of the United States.

(b) EFFECT OF ELECTION.—If the election provided in subsection (a) is effective for a taxable year—

(1) the regulated investment company—

(A) shall not, with respect to such taxable year, be allowed a

deduction under section 164(a) or a credit under section 901 for taxes to which subsection (a) is applicable, and

(B) shall be allowed as an addition to the dividends paid deduction for such taxable year the amount of such taxes;

(2) each shareholder of such investment company shall—

(A) include in gross income and treat as paid by him his proportionate share of such taxes, and

(B) treat as gross income from sources within the respective foreign countries and possessions of the United States, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and the portion of any dividend paid by such investment company which represents income derived from sources within foreign countries or possessions of the United States.

(c) NOTICE TO SHAREHOLDERS.—The amounts to be treated by the shareholder, for purposes of subsection (b)2, as his proportionate share of—

(1) taxes paid to any foreign country or possession of the United States, and

(2) gross income derived from sources within any foreign country or possession of the United States, shall not exceed the amounts so designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year.

(d) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (a) and the notice to shareholders required by subsection (c) shall be made in such manner as the Secretary or his delegate may prescribe by regulations.

(e) CROSS REFERENCES.—

(1) For treatment by shareholders of taxes paid to foreign countries and possessions of the United States, see section 164(a) and section 901.

(2) For definition of foreign corporation, see section 7701(a)(5).

§ 1.853-1 FOREIGN TAX CREDIT ALLOWED TO SHAREHOLDERS.—(a) *In general.*—Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b)(1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164(a)) as provided by section 853(b)(2) and § 1.853-2(b). The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

(b) *Requirements.*—To qualify for the election provided in section 853(a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852(a) and § 1.852-1(a). The term “value”, for purposes of the first requirement, is defined in section 851(c)(4). For the definition of foreign corporation, see section 7701(a).

§ 1.853-2 EFFECT OF ELECTION.—(a) *Regulated investment company*.—A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853(a) is, for such year, denied both the deduction for foreign taxes provided by section 164(a) and the credit for foreign taxes provided by section 901 with respect to all income, war-profits, and excess profits taxes (described in section 901(b)(1)) which it has paid to any foreign country or possession of the United States. See section 853(b)(1)(A). However, under section 853(b)(1)(B) the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See § 1.852-1(a).

(b) *Shareholder*.—Under section 853(b)(2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) *Dividends paid after the close of the taxable year*.—For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855(d) and § 1.855-1(f).

(d) *Example*.—This section may be illustrated as follows:

(1) The X Corporation, a regulated investment company, has total assets, at the close of the taxable year, of \$10 million invested as follows:

Domestic corporations .....	\$4,000,000
Foreign corporations in:	
Country A .....	\$3,500,000
Country B .....	2,500,000
	<hr/>
	6,000,000
Total assets .....	\$10,000,000

(2) The dividend income of X Corporation is received from the following sources:

Domestic corporations .....	\$300,000
Foreign corporations:	
Country A .....	\$250,000
Country B .....	250,000
	<hr/>
	500,000
Total dividend income .....	\$800,000
Operation and management expenses .....	80,000
	<hr/>
Net dividend income .....	\$720,000

Taxes withheld by Country A on dividends of \$250,000 at a rate of 10 percent .....	\$25,000
Taxes withheld by Country B on dividends of \$250,000 at a rate of 20 percent .....	50,000
Total foreign taxes withheld .....	75,000
Income available for distribution .....	<u>\$645,000</u>

(3) X Corporation has 250,000 shares of common stock outstanding and distributes the entire \$645,000 as a dividend of \$2.58 per share of stock.

(4) The X Corporation meets the 50 percent requirement of section 851(b) (4) and the requirements of section 852(a). It notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election they are to treat as foreign taxes paid \$0.30 per share of stock (\$75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which \$0.20 represents taxes paid to Country B and \$0.10 taxes paid to Country A. The shareholders must report as income \$2.88 per share (\$2.58 of dividends actually received plus the \$0.30 representing foreign taxes paid). Of the \$2.88 per share, \$1.80 per share (\$450,000 (which represents such part of the net dividend income of \$720,000 as the foreign dividend income of \$500,000 bears to the total dividend income of \$800,000) divided by 250,000 shares) is to be considered as received from foreign sources. Ninety cents is to be considered as received from Country A, and ninety cents from Country B.

§ 1.853-3 NOTICE TO SHAREHOLDERS.—If a regulated investment company makes an election under section 853(a), in the manner provided in § 1.853-4, the investment company is required, under section 853(c), to furnish its shareholders with a written notice mailed not less than 30 days after the close of its taxable year. The notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. For purposes of section 853(b) (2) and § 1.853-2(b), the amount that a shareholder may treat as his proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country or possession of the United States shall not exceed the amounts so designated by the company in such written notice. If, however, the amount designated by the company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

§ 1.853-4 MANNER OF MAKING ELECTION.—(a) *General rule.*—A regulated investment company, to make a valid election under section 853, must—

(1) File with Form 1099 and Form 1096 a statement as part of its return which sets forth the following information:

(i) The total amount of income received from sources within foreign countries and possessions of the United States;

(ii) The total amount of income, war-profits, or excess profits taxes (described in section 901(b)(1)) paid, or deemed to have been paid under the provisions of any treaty to which the United States is a party, to such foreign countries or possessions;

(iii) The date, form, and contents of the notice to its shareholders;

(iv) The proportionate share of such taxes paid during the taxable year and foreign income received during such year attributable to one share of stock of the regulated investment company; and

(2) File as part of its return for the taxable year a Form 1118 modified so that it becomes a statement in support of the election made by a regulated investment company for taxes paid to a foreign country or a possession of the United States.

(b) *Irrevocability of the election.*—The election is applicable only with respect to taxable years subject to the Internal Revenue Code of 1954, shall be made with respect to all such foreign taxes, and must be made not later than the time prescribed for filing the return (including extensions thereof). Such election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

#### § 1.854 STATUTORY PROVISIONS; LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANY.

##### SEC. 854. LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANY.

(a) **CAPITAL GAIN DIVIDEND.**—For purposes of section 34(a) (relating to credit for dividends received by individuals), section 116 (relating to an exclusion for dividends received by individuals), and section 243 (relating to deductions for dividends received by corporations), a capital gain dividend (as defined in section 852(b)(3)) received from a regulated investment company shall not be considered as a dividend.

(b) **OTHER DIVIDENDS.**—

(1) **GENERAL RULE.**—In the case of a dividend received from a regulated investment company (other than a dividend to which subsection (a) applies)—

(A) if such investment company meets the requirements of section 852(a) for the taxable year during which it paid such dividends; and

(B) the aggregate dividends received by such company during such taxable year are less than 75 percent of its gross income, then, in computing the credit under section 34(a), the exclusion under section 116, and the deduction under section 243, there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as the aggregate dividends received by such company during such taxable year bear to its gross income for such taxable year.

(2) **NOTICE TO SHAREHOLDERS.**—The amount of any distribution by a regulated investment company which may be taken into account as a dividend for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243 shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 30 days after the close of its taxable year.

(3) **DEFINITIONS.**—For purposes of this subsection—

(A) The term “gross income” does not include gain from the sale or other disposition of stock or securities.

(B) The term “aggregate dividends received” includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends excluded from gross

income). In determining the amount of any dividend for purposes of this subparagraph, the rules provided in section 116(c) (relating to certain distributions) shall apply.

§ 1.854-1 LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANY.—(a) *In general.*—Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the credit under section 34 and the exclusion under section 116 for dividends received by individuals, and the deduction under section 243 for dividends received by corporations.

(b) *Capital gain dividend.*—Under the provisions of section 854(a) a capital gain dividend as defined in section 852(b) (3) and § 1.852-4(b) shall not be considered a dividend for purposes of the credit under section 34, the exclusion under section 116, or the deduction under section 243.

(c) *Rule for dividends other than capital gain dividends.*—(1) Section 854(b) (1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the “aggregate dividends received” (as defined in section 854(b) (3) (B) and § 1.854-3(b)) during the taxable year by a regulated investment company (which meets the requirements of section 852(a) and § 1.852-1(a) for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year (as defined in section 854(b) (3) (A) and § 1.854-3(a)), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

*Example.* The XYZ regulated investment company meets the requirements of section 852(a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities).....	\$100,000
Dividends (from domestic sources other than dividends described in section 116(b)) .....	70,000
Dividend (from foreign corporations) .....	5,000
Interest .....	25,000
<hr/> Total .....	<hr/> \$200,000
Expenses .....	20,000
<hr/> Taxable income .....	<hr/> \$180,000



The regulated investment company decides to distribute the entire \$180,000. It distributes a capital gain dividend of \$100,000 and a dividend of ordinary income of \$80,000. The aggregate dividends received by the regulated investment company from domestic corporations (\$70,000) is less than 75 percent of its gross income (\$100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since \$70,000 is 70 percent of \$100,000, out of every \$1 dividend of ordinary income paid by the regulated investment company only cents would be available for the credit, exclusion, or deduction referred to in section 854(b)(1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) *Dividends received from a regulated investment company during taxable years of shareholders ending after July 31, 1954, and subject to the Internal Revenue Code of 1939.*—For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see § 1.854-5 and § 1.116-2.

§ 1.854-2 NOTICE TO SHAREHOLDERS.—Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the credit for dividends received by individuals provided by section 34(a), the exclusion for dividends received by individuals provided by section 116, and the deduction for dividends received by corporations provided by section 243, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 30 days after the close of the company's taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854(b)(1) and § 1.854-1(c).

§ 1.854-3 DEFINITIONS.—(a) For the purpose of computing the limitation prescribed by section 854(b)(1)(B) and § 1.854-1(c), the term "gross income" does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of "aggregate dividends received". In determining the amount of any dividend for purposes of this section, the rules provided in section 116(c) (relating to certain distributions) shall apply.

§ 1.855 STATUTORY PROVISIONS; DIVIDENDS PAID BY REGULATED INVESTMENT COMPANY AFTER CLOSE OF TAXABLE YEAR.

SEC. 855. DIVIDENDS PAID BY REGULATED INVESTMENT COMPANY AFTER CLOSE OF TAXABLE YEAR.

(a) GENERAL RULE.—For purposes of this chapter, if a regulated investment company—

(1) declares a dividend prior to the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and

(2) distributes the amount of such dividend to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration,

the amount so declared and distributed shall, to the extent the company elects in such return in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been paid during such taxable year, except as provided in subsections (b), (c) and (d).

(b) RECEIPT BY SHAREHOLDER.—Amounts to which subsection (a) is applicable shall be treated as received by the shareholder in the taxable year in which the distribution is made.

(c) NOTICE TO SHAREHOLDERS.—In the case of amounts to which subsection (a) is applicable, any notice to shareholders required under this subchapter with respect to such amounts shall be made not later than 30 days after the close of the taxable year in which the distribution is made.

(d) FOREIGN TAX ELECTION.—If an investment company to which section 853 is applicable for the taxable year makes a distribution as provided in subsection (a) of this section, the shareholders shall consider the amounts described in section 853(b)(2) allocable to such distribution as paid or received, as the case may be, in the taxable year in which the distribution is made.

§ 1.855-1 DIVIDENDS PAID BY REGULATED INVESTMENT COMPANY AFTER CLOSE OF TAXABLE YEAR.—(a) *General rule.*—In—

(1) Determining under section 852(a) and § 1.852-1(a) whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852(b)(2)(D)),

(2) Computing its investment company taxable income (under section 852(b)(2) and § 1.852-3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and § 1.852-4(b)) paid during the taxable year,

any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is actually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) *Election.*—(1) *Method of making election.*—The election must be made in the return filed by the company for the taxable year.

The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852(c) and § 1.852-5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855(a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election.*—After the expiration of the time for filing the return for the taxable year for which an election is made under section 855(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.*—Under section 855(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) *Examples.*—The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

*Example (1).* The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of \$100,000. During that year the company distributed to shareholders taxable dividends aggregating \$88,000. On March 10, 1955, the company declared a dividend of \$37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of \$25,000 plus an additional \$12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its Federal income tax return and elected therein to treat \$12,000 of the total dividend of \$37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of \$37,000 on March 20, 1955, an amount equal to \$12,000 thereof will be treated for the purposes of section 852(a) as having been paid during the taxable year 1954. Such amount (\$12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

*Example (2).* The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year

1954 of \$100,000, and for 1955 taxable income (and earnings or profits) of \$125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of \$115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating \$85,000. On March 5, 1955, the company declared a dividend of \$65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its Federal income tax return in which it included \$40,000 of the total dividend of \$65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of \$65,000 declared on March 5, 1955. The election under section 855(a) is valid only to the extent of \$15,000, the amount of the undistributed earnings and profits for 1954 (\$100,000 earnings and profits less \$85,000 distributed during 1954). The remainder (\$50,000) of the \$65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year 1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of \$75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of \$65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of \$15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining \$50,000 as a distribution of the earnings or profits for the year 1955. The distribution of \$75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) *Notice to shareholders.*—Section 855(c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855(a), any notice to shareholders required under subchapter M, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and § 1.852-4(b) with respect to capital gain dividends, section 853(c) and § 1.853-3 with respect to allowance to shareholder of foreign tax credit, and section 854(b)(2) and § 1.854-2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 855(c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-

term capital loss of the company. See section 852(b)(3)(C) and § 1.852-4(b).

(f) *Foreign tax election*.—Section 855(d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES  
DETERMINATION OF SOURCES OF INCOME

§ 1.861 STATUTORY PROVISIONS; INCOME FROM SOURCES WITHIN  
THE UNITED STATES.

SEC. 861. INCOME FROM SOURCES WITHIN THE UNITED STATES.

(a) GROSS INCOME FROM SOURCES WITHIN UNITED STATES.—The following items of gross income shall be treated as income from sources within the United States:

(1) INTEREST.—Interest from the United States, any Territory, political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

(A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States,

(B) interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Secretary or his delegate that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable, and

(C) income derived by a foreign central bank of issue from bankers' acceptances.

(2) DIVIDENDS.—The amount received as dividends—

(A) from a domestic corporation other than a corporation entitled to the benefits of section 931, and other than a corporation less than 20 percent of whose gross income is shown to the satisfaction of the Secretary or his delegate to have been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or

(B) from a foreign corporation unless less than 50 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this part; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends.

(3) PERSONAL SERVICES.—Compensation for labor or personal services performed in the United States; except that compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if—

(A) the labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,

(B) such compensation does not exceed \$3,000 in the aggregate, and

(C) the compensation is for labor or services performed as an employee of or under a contract with—

(i) a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such corporation.

(4) **RENTALS AND ROYALTIES.**—Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.

(5) **SALE OF REAL PROPERTY.**—Gains, profits, and income from the sale of real property located in the United States.

(6) **SALE OF PERSONAL PROPERTY.**—Gains, profits, and income derived from the purchase of personal property without the United States (other than within a possession of the United States) and its sale within the United States.

(b) **TAXABLE INCOME FROM SOURCES WITHIN UNITED STATES.**—From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

§ 1.861-1 **INCOME FROM SOURCES WITHIN THE UNITED STATES.**—  
(a) *Categories of income.*—Sections 861 to 864, inclusive, and the regulations thereunder, determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.*—The gross income from sources within the United States, consisting of the items of gross income specified in section 861 (a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863 (a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861 (b) and 863 (a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.861-8 and 1.863-1.

(2) *Without the United States.*—The gross income from sources without the United States, consisting of the items of gross income

specified in section 862 (a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863 (a). See §§ 1.862-1 and 1.863-1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862 (b) and 863 (a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862-1 and 1.863-1.

(3) *Partly within and partly without the United States.*—The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863 (b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863-2 to 1.863-5, inclusive.

(b) *Taxable income from sources within the United States.*—The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a) (1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a) (3) of this section.

(c) *Computation of income.*—If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

§ 1.861-2 INTEREST.—(a) *General.*—There shall be included in the gross income from sources within the United States all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except—

(1) *Deposits.*—Interest paid on deposits with persons, including individuals, partnerships, or corporations, carrying on the banking business, to persons not engaged in business within the United States;

(2) *Payer deriving income abroad.*—Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income of such resident payer or domestic corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of the payer which precedes the payment of such interest, or for such part of that period as may be applicable; and

(3) *Bankers' acceptances.*—Income derived by a foreign central  
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bank of issue from bankers' acceptances. A foreign central bank of issue means a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such banks are generally the custodians of the banking reserves of their countries.

(b) *Interest on refunds.*—Interest received from the United States on a refund of Federal income taxes constitutes income from sources within the United States.

(c) *Statement with return.*—Any taxpayer who excludes from gross income items of the type specified in paragraph (a) (1), (2), or (3) of this section shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified therein.

§ 1.861-3 **DIVIDENDS.**—(a) *General.*—Gross income from sources within the United States includes dividends, as defined by section 913 and the regulations thereunder, from—

(1) *Domestic corporation.*—A domestic corporation other than one entitled to the benefits of section 931, and other than a corporation less than 20 percent of the gross income of which is derived to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends, or for such part of such period as the corporation has been in existence; or

(2) *Foreign corporation.*—A foreign corporation unless less than 50 percent of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends, or for such part of such period as it has been in existence, was derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for purposes of sections 901 to 905, inclusive, and the regulations thereunder, relating to the foreign tax credit, dividends from a foreign corporation shall be treated as income from sources within the United States to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends.

(b) *Presumption as to source.*—Dividends will be treated as income from sources within the United States (except for purposes of sections 901 to 905, inclusive, and the regulations thereunder) unless the taxpayer submits with his return sufficient data to establish to the satisfaction of the district director (or, if applicable, the Director of International Operations) that, in accordance with paragraph (a) (1) or (2) of this section, they are not income from sources within the United States.

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§ 1.861-4 COMPENSATION FOR LABOR OR PERSONAL SERVICES.—(a) *General*.—Gross income from sources within the United States includes compensation for labor or personal services performed in the United States regardless of the residence of the payer, of the place in which the contract for service was made, or of the place of payment; except that such compensation shall be deemed not to be income from sources within the United States, if—

(1) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year;

(2) The compensation does not exceed \$3,000 in the aggregate; and

(3) The compensation is for labor or services performed as an employee of, or under a contract with,—

(i) A nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) A domestic corporation, if the labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by that corporation.

(b) *Amount includible in gross income*.—If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

(c) *Coastwise travel*.—Except as to income excluded by paragraph (a) of this section, wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

§ 1.861-5 RENTALS AND ROYALTIES.—Gross income from sources within the United States includes rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, in the United States, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States.

§ 1.861-6 SALE OF REAL PROPERTY.—Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale

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or other disposition of real property located in the United States. For the treatment of capital gains and losses, see sections 1201 to 1241, inclusive, and the regulations thereunder.

§ 1.861-7 SALE OF PERSONAL PROPERTY.—(a) *General*.—Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession*.—Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863(b) (3) and § 1.863-2.

(c) *Country in which sold*.—For the purposes of sections 861 to 864, inclusive, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale*.—For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863 (b) (2) and §§ 1.863-1 (b) and 1.863-2.

(e) *Section 306 stock*.—For determining the source of gain on the disposition of section 306 stock, see section 306 (f) and the regulations thereunder.

§ 1.861-8 COMPUTATION OF TAXABLE INCOME FROM SOURCES WITHIN THE UNITED STATES.—(a) *General*.—From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

*Example.* A taxpayer engaged in trade or business receives for the taxable year gross income from all sources in the amount of

\$180,000, one-fifth of which (\$36,000) is from sources within the United States, computed as follows:

Interest on bonds of a domestic corporation.....	\$9,000
Dividends on stock of a domestic corporation.....	4,000
Royalty for the use within the United States of patents.....	12,000
Gain from sale of real property located within the United States....	11,000
Total .....	\$36,000

The remainder of the gross income is from sources without the United States, as determined under § 1.862-1. The expenses of the taxpayer for the year amount to \$78,000. Of these expenses the amount of \$8,000 is properly allocated to income from sources within the United States, and the amount of \$40,000 is properly allocated to income from sources without the United States. The remainder of the expenses (\$30,000) cannot be definitely allocated to any item or class of gross income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing taxable income from sources within the United States. Thus, there are deducted from the \$36,000 of gross income from sources within the United States expenses amounting to \$14,000, representing \$8,000 properly apportioned to the income from sources within the United States and \$6,000 of the expenses (one-fifth thereof) which cannot definitely be allocated to any item or class of gross income. The remainder (\$22,000) is the taxable income from sources within the United States.

(b) *Personal exemptions*.—The deductions for the personal exemptions allowed by section 151 or 642(b) shall not be taken into account for purposes of paragraph (a) of this section but shall be allowed as deductions from the taxable income computed thereunder, if and to the extent that such deductions are allowable for purposes of computing the taxable income of the taxpayer. See sections 641(b), 873(d), 904(b), and 931(e), and the regulations thereunder.

(c) *Special deductions*.—The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax-exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be taken into account for purposes of paragraph (a) of this section.

(d) *Exempt income*.—No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income. See section 265 and the regulations thereunder.

## § 1.862 STATUTORY PROVISIONS; INCOME FROM SOURCES WITHOUT THE UNITED STATES.

### SEC. 862. INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) *GROSS INCOME FROM SOURCES WITHOUT UNITED STATES*.—The following items of gross income shall be treated as income from sources without the United States:

(1) interest other than that derived from sources within the United States as provided in section 861(a)(1);

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(2) dividends other than those derived from sources within the United States as provided in section 861(a)(2);

(3) compensation for labor or personal services performed without the United States;

(4) rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties;

(5) gains, profits, and income from the sale of real property located without the United States; and

(6) gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(b) **TAXABLE INCOME FROM SOURCES WITHOUT UNITED STATES.**—From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States.

§ 1.862-1 **INCOME SPECIFICALLY FROM SOURCES WITHOUT THE UNITED STATES.**—(a) *Gross income.*—The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that specified in section 861(a)(1) as being derived from sources within the United States;

(2) Dividends other than those derived from sources within the United States as provided in section 861(a)(2);

(3) Compensation for labor or personal services performed without the United States (for the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see paragraph (b) of § 1.861-4);

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property;

(5) Gains, profits, and income from the sale of real property located without the United States; and

(6) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States. Income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within that possession of the United States. For determining the time and place of sale of personal property for purposes of this subparagraph see paragraph (c) of § 1.861-7.

(b) *Taxable income.*—The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in § 1.861-8 for determining the taxable income from sources within the United States.

§ 1.863 STATUTORY PROVISIONS; ITEMS NOT SPECIFIED IN SECTION 861 OR 862.

SEC. 863. ITEMS NOT SPECIFIED IN SECTION 861 OR 862.

(a) *ALLOCATION UNDER REGULATIONS.*—Items of gross income, expenses, losses, and deductions, other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary or his delegate. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

(b) *INCOME PARTLY FROM WITHIN AND PARTLY FROM WITHOUT THE UNITED STATES.*—In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary or his delegate. Gains, profits, and income—

(1) from transportation or other services rendered partly within and partly without the United States,

(2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, or

(3) derived from the purchase of personal property within a possession of the United States and its sale within the United States, shall be treated as derived partly from sources within and partly from sources without the United States.

§ 1.863-1 ALLOCATION OF GROSS INCOME UNDER SECTION 863(a).—

(a) *General.*—Items of gross income other than those specified in section 861(a) (§§ 1.861-2 to 1.861-7, inclusive) and section 862(a) (§ 1.862-1) shall be allocated or apportioned to sources within or without the United States, as provided in section 863(a); however, see § 1.863-2 for alternative method of determining the taxable income from sources within the United States in the case of the items specified in paragraph (b) of § 1.863-2.

(b) *Natural resources.*—The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that, due to the peculiar conditions of production and sale in a specific case or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided by section 863(b) and § 1.863-2.

(c) *Taxable income.*—The taxable income from sources within or

without the United States, in the case of the items of gross income allocated under section 863(a), shall be determined on the same basis as that used in § 1.861-8 for determining the taxable income from sources within the United States. See also paragraph (b) of § 1.862-1.

§ 1.863-2 INCOME DERIVED PARTLY FROM SOURCES WITHIN AND PARTLY FROM SOURCES WITHOUT THE UNITED STATES.—(a) *General*.—Section 863(b) provides an alternative method for determining the taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method the entire taxable income in the case of such income is first determined by deducting the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. Then, pursuant to processes or formulas of general apportionment prescribed by the Secretary or his delegate, a portion of such entire taxable income is determined as being attributable to sources within the United States. Thus, the income treated as derived partly from sources within and partly from sources without the United States may be allocated to sources within or without the United States pursuant to § 1.863-1 or apportioned to such sources in accordance with the method described in this section.

(b) *Applicable items*.—The income to which this section applies (and which is treated as derived partly from sources within and partly from sources without the United States) shall consist of gains, profits, and income—

(1) From transportation or other services rendered partly within and partly without the United States;

(2) From the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States.

(c) *Cross reference*.—For allocation or apportionment under § 1.863-1 or this section in the case of the principal items to which this section applies, see §§ 1.863-3, 1.863-4, and 1.863-5.

§ 1.863-3 INCOME FROM THE SALE OF PERSONAL PROPERTY DERIVED PARTLY FROM WITHIN AND PARTLY FROM WITHOUT THE UNITED STATES.—(a) *General*.—(1) *Classes of income*.—Income from the sale of property to which paragraph (b) (2) and (3) of § 1.863-2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition*.—For purposes of this section, the word “produced” includes created, fabricated, manufactured, extracted, processed,

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cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of § 1.861-7.

(b) *Income partly from sources within a foreign country.*—(1) *General.*—This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863 (b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment.*—The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861-8 shall be taken into account.

*Example (1).* Where the manufacturer, or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

*Example (2).* (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value

of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such taxable income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country.

(iii) The term "gross sales", as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis.

(v) Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

*Example (3).* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States.

(c) *Income partly from sources within a possession of the United States.*—(1) *General.*—This paragraph relates to gains, profits, and income which, pursuant to section 863(b), are treated as derived partly from sources within the United States and partly from sources within a possession of the United States. The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.*—The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set



forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861-8 shall be taken into account.

(3) *Personal property produced and sold.*—This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

*Example (1).* Same as example (1) under paragraph (b) (2) of this section.

*Example (2).* (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal prop-

erty within a possession of the United States and its sale within the United States. The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales.

*Example (3).* Same as example (3) under paragraph (b) (2) of this section.

(4) *Personal property purchased and sold.*—This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

*Example (1).* (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

*Example (2).* Same as example (3) under paragraph (b) (2) of this section.

§ 1.863-4 TRANSPORTATION SERVICE.—(a) *General.*—A taxpayer carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.*—The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.*—In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses.*—(1) *Taxes and interest.*—Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f) (2) of this section.

(2) *Other business activity and general expenses.*—If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f) (3) of this section.

(3) *Personal exemptions and special deductions.*—The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861-8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States.*—(1) *General.*—The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a

reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.*—For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.*—Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income.*—(1) *General.*—In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.*—Interest and income, war profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income, there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.*—General expenses, losses, or deductions shall

be deducted under this paragraph to the extent indicated in paragraph (d) (2) of this section.

(4) *Personal exemptions*.—The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861-8.

(5) *Special deductions*.—The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861-8.

(g) *Allocation based on books of account*.—Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraph (b) to (f), inclusive, of this section.

§ 1.863-5 TELEGRAPH AND CABLE SERVICES.—(a) *General*.—A taxpayer carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income*.—The gross income from sources within the United States derived from such services shall be determined by adding the gross revenues derived from messages originating in the United States and amounts collected abroad on collect messages originating in the United States and then deducting from such sum amounts paid or accrued for transmission of messages beyond the taxpayer's own circuit. Amounts received by the taxpayer in the United States with respect to collect messages originating without the United States shall be excluded from such gross income.

(c) *Taxable income*.—In computing taxable income from sources within the United States, the following items shall be allowed as deductions from the gross income determined in accordance with paragraph (b) of this section:

(1) All expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States;

(2) All direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables and not including any amount already deducted in computing gross income);

(3) Depreciation of property (other than cables) located in the United States and used in the trade or business therein; and,

(4) A proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in subparagraphs (1), (2), and (3) of this paragraph) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise, based on the ratio which the number

ords originating in the United States bears to the total words  
mitted by the enterprise.

) The deductions for the personal exemptions, and the special  
ctions allowed by sections 241, 922, and 941, but only to the  
nt provided by paragraphs (b) and (c) of § 1.861-8.

363-6 INCOME FROM SOURCES WITHIN A FOREIGN COUNTRY OR  
SION OF THE UNITED STATES.—The principles applied in  
61-1 to 1.863-5, inclusive, for determining the gross and the  
e income from sources within and without the United States  
e applied, for purposes of the income tax, in determining the  
and the taxable income from sources within and without a  
n country, or within and without a possession of the United

## 864 STATUTORY PROVISIONS; DEFINITIONS.

### 864. DEFINITIONS.

or purposes of this part, the word "sale" includes "exchange"; the  
1 "sold" includes "exchanged"; and the word "produced" includes  
ated", "fabricated", "manufactured", "extracted", "processed", "cured",  
aged".

## NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

### NONRESIDENT ALIEN INDIVIDUALS

## 871 STATUTORY PROVISIONS; TAX ON NONRESIDENT ALIEN INDIVIDUALS.

### 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

a) No UNITED STATES BUSINESS AND GROSS INCOME OF NOT MORE  
AN \$15,400.

(1) IMPOSITION OF TAX.—Except as otherwise provided in subsection

b) there is hereby imposed for each taxable year, in lieu of the tax  
imposed by section 1, on the amount received, by every nonresident alien  
individual not engaged in trade or business within the United States,  
from sources within the United States, as interest (except interest on  
deposits with persons carrying on the banking business), dividends,  
rents, salaries, wages, premiums, annuities, compensations, remunera-  
tions, emoluments, or other fixed or determinable annual or periodical  
gains, profits, and income (including amounts described in section 402  
(a) (2), section 631(b) and (c), and section 1235, which are considered  
to be gains from the sale or exchange of capital assets), a tax of 30  
percent of such amount.

(2) CAPITAL GAINS OF ALIENS TEMPORARILY PRESENT IN THE UNITED  
STATES.—In the case of a nonresident alien individual not engaged in  
trade or business in the United States, there is hereby imposed for each  
taxable year, in addition to the tax imposed by paragraph (1)—

(A) if he is present in the United States for a period or periods  
aggregating less than 90 days during such taxable year—a tax of 30  
percent of the amount by which his gains, derived from sources within  
the United States, from his sales or exchanges of capital assets effected  
during his presence in the United States exceed his losses, allocable  
to sources within the United States, from such sales or exchanges  
effected during such presence; or

(B) if he is present in the United States for a period or periods  
aggregating 90 days or more during such taxable year—a tax of 30  
percent of the amount by which his gains, derived from sources within  
the United States, from sales or exchanges of capital assets effected  
at any time during such year exceed his losses, allocable to sources

within the United States, from such sales or exchanges effected at any time during such year.

For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such individual were engaged in trade or business in the United States, except that such gains and losses shall be computed without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212.

(b) **NO UNITED STATES BUSINESS AND GROSS INCOME OF MORE THAN \$15,400.**—A nonresident alien individual not engaged in trade or business within the United States shall be taxable without regard to subsection (a) if during the taxable year the sum of the aggregate amount received from the sources specified in subsection (a) (1), plus the amount by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges (determined in accordance with subsection (a) (2)) is more than \$15,400, except that—

(1) the gross income shall include only income from the sources specified in subsection (a) (1) plus any gain (to the extent provided in subchapter P; sec. 1201 and following, relating to capital gains and losses) from a sale or exchange of a capital asset if such gain would be taken into account were the tax being determined under subsection (a) (2);

(2) the deductions (other than the deduction for charitable contributions and gifts provided in section 873(c)) shall be allowed only if and to the extent that they are properly allocable to the gross income from the sources specified in subsection (a), except that any loss from the sale or exchange of a capital asset shall be allowed (to the extent provided in subchapter P without the benefit of the capital loss carryover provided in section 1212) if such loss would be taken into account were the tax being determined under subsection (a) (2);

(3) the taxes imposed by this subtitle (under section 1, or under section 1201(b)) shall, in no case, be less than 30 percent of the sum of—

(A) the aggregate amount received from the sources specified in subsection (a) (1), plus

(B) the amount, determined under subsection (a) (2), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges.

(c) **UNITED STATES BUSINESS.**—A nonresident alien individual engaged in trade or business within the United States shall be taxable without regard to subsection (a). For purposes of part I, this section, sections 881 and 882, and chapter 3, the term "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year, but does not include the performance of personal services—

(1) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(2) for an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate \$3,000. Such term does not include the effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in stocks or securities, or in commodities (if of a kind customarily dealt in on an organized commodity exchange, if the transaction is of the kind customarily consummated at such place, and if the alien, partnership, or corporation has no office or place of business in the United States at any time during the taxable year through which or by the direction of which such transactions in commodities are effected).

(d) **DOUBLING OF TAX.**—For doubling of tax on citizens of certain foreign countries, see section 891.

§ 1.871-1 **TAXATION OF ALIENS.**—For purposes of the income tax, alien individuals are divided generally into two classes, namely, resi-

dent aliens and nonresident aliens. Resident aliens are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. Nonresident aliens are taxable only on income from sources within the United States. For classification of nonresident aliens, see § 1.871-7. For determination of the sources of income, see §§ 1.861-1 to 1.863-6, inclusive.

§ 1.871-2 DETERMINING RESIDENCE OF ALIEN INDIVIDUALS.—(a) *General*.—The term “nonresident alien individual” means an individual whose residence is not within the United States, and who is not a citizen of the United States. The term includes a nonresident alien fiduciary. For such purpose the term “fiduciary” shall have the meaning assigned to it by section 7701(a)(6) and the regulations thereunder. For presumption as to an alien’s nonresidence, see paragraph (b) of § 1.871-4.

(b) *Residence defined*.—An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

§ 1.871-3 RESIDENCE OF ALIEN SEAMEN.—In order to determine whether an alien seaman is a resident of the United States for purposes of the income tax, it is necessary to decide whether the presumption of nonresidence (as prescribed by paragraph (b) of § 1.871-4) is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 1.871-4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailor’s boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence



in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient.

§ 1.871-4 PROOF OF RESIDENCE OF ALIENS.—(a) *Rules of evidence.*—The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein for purposes of the income tax.

(b) *Nonresidence presumed.*—An alien, by reason of his alienage, is presumed to be a nonresident alien.

(c) *Presumption rebutted.*—(1) *Departing alien.*—In the case of an alien who presents himself for determination of tax liability before departure from the United States, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That he alien, at least six months before the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) *Other aliens.*—In the case of other aliens, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(d) *Certificate.*—If, in the application of paragraph (c) (1) (iii) or (2) (iii) of this section, the internal revenue officer or employee who examines the alien is in doubt as to the facts, such officer or employee may, to assist him in determining the facts, require a certificate or certificates setting forth the facts relied upon by the alien seeking to overcome the presumption. Each such certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months before the date of execution of the certificate or certificates.

§ 1.871-5 LOSS OF RESIDENCE BY AN ALIEN.—An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§ 1.871-4(a)

§ 1.871-6 DUTY OF EMPLOYER TO DETERMINE STATUS OF ALIEN EMPLOYEE.—(a) *Proof of status required.*—If wages are paid to an alien without withholding the tax under chapter 3 of the 1954 Code, or, if applicable, under section 143 of the 1939 Code, except insofar as the regulations thereunder permit exemption from withholding, then the employer must be prepared to prove the status of the alien as provided in §§ 1.871-1 to 1.871-5, inclusive.

(b) *Evidence of residence.*—An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078 or an equivalent written statement. In the case of payments made after December 31, 1956, this statement or form shall be filed in the manner prescribed in § 1.1441-5. An employer need not secure Form 1078 or written statement from the alien employee if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he did not at that time secure Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent evidence.

§ 1.871-7 TAX ON NONRESIDENT ALIEN INDIVIDUALS.—(a) *Classes of nonresident aliens.*—For purposes of the income tax, nonresident alien individuals are divided into four classes:

(1) *Class 1.*—Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and receiving in such year an aggregate of not more than \$15,400 gross income (determined without regard to section 116) from sources within the United States consisting of—

- (i) Fixed or determinable annual or periodical income, and
- (ii) Amounts constituting, or considered to be, gains from the sale or exchange of capital assets, as described in paragraph (b) of this section;

(2) *Class 2.*—Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and receiving in such year an aggregate of more than \$15,400 gross income (determined without regard to section 116) described under class 1;

(3) *Class 3.*—Nonresident alien individuals who at any time during the taxable year are engaged in trade or business within the United States; and

(4) *Class 4.*—Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

Individuals within classes 1 to 3, inclusive, are subject to tax pursuant to the provisions of sections 871 to 877, inclusive, and the regulations thereunder. The provisions of those sections do not apply to individuals within class 4, but such individuals are subject to the tax imposed by section 1. See § 1.876-1. If the gross income of a nonresident alien individual includes income on which the tax is limited by tax convention, see paragraph (e) of this section.

(b) *No United States business; gross income of not more than \$15,400.*—(1) *Imposition of tax.*—Except as otherwise provided by paragraph (e) of this section, a nonresident alien individual within class 1 is not subject to the tax imposed by section 1 but, pursuant to the provisions of section 871(a), is liable to a flat tax of 30 percent

upon the aggregate of the amounts determined under subparagraphs (2), (3), and (4) of this paragraph and received during the taxable year from sources within the United States. For this purpose the source of the income shall be determined in accordance with the provisions of sections 861 to 864, inclusive, and the regulations thereunder. For the purposes of section 871(a)(1) "amount received" means "gross income."

(2) *Fixed or determinable annual or periodical income.*—(i) *Items subject to tax.*—The tax of 30 percent applies to the gross amount received as fixed or determinable annual or periodical gains, profits, and income. Specific items of fixed or determinable annual or periodical income are enumerated in section 871(a)(1) as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax as, for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441-2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income, see section 306 (f) and the regulations thereunder.

(ii) *Losses.*—In computing the income subject to tax under this subparagraph no deduction shall be allowed for any loss sustained during the taxable year.

(3) *Amounts considered to be capital gains.*—(i) *Items subject to tax.*—The tax of 30 percent also applies, pursuant to the provisions of section 871(a)(1), to amounts received during the taxable year from sources within the United States which are described in section 402(a)(2), section 631(b) and (c), and section 1235 and are considered to be gains from the sale or exchange of capital assets. Thus, the tax applies to gain recognized on certain distributions by a qualified employees' trust where the total distributions, with respect to any employee, are payable to the distributee within one taxable year; to gain recognized under specified circumstances on the disposal of timber and coal and considered in accordance with section 1231 to be gain from the sale or exchange of a capital asset; and to gain recognized on certain transfers of patent rights by an individual.

(ii) *Ninety-day rule not applicable.*—The provisions of section 871(a)(2) do not apply to the gains described in this subparagraph; as a consequence, the taxpayer receiving these gains during a taxable year is subject to the tax of 30 percent thereon without regard to the 90-day rule of that section and even though he has not been present in the United States at any time during the taxable year.

(iii) *Recognized gain fully taxable.*—The tax of 30 percent imposed upon the gains described in this subparagraph shall apply (a) to the full amount of gain recognized upon the transaction, (b) without regard to the alternative tax imposed by section 1201 upon the excess of the net long-term capital gain over the net short-term capital loss, and (c) without regard to the deduction allowed by section 1202 in respect of capital gain.

(iv) *Losses.*—In computing the gain subject to tax under this subparagraph no deduction shall be allowed for any loss sustained dur-

ing the taxable year, even though the loss is taken into account under section 1231 in determining whether the gain is considered to be gain from the sale or exchange of a capital asset.

(4) *Capital gains and losses.*—(i) *Items subject to tax.*—The tax of 30 percent also applies, pursuant to the provisions of section 871 (a) (2), to the excess of capital gains derived from sources within the United States over capital losses allocable to such sources, determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, and in accordance with the provisions of this subparagraph.

(ii) *Present less than 90 days.*—If he has been present in the United States for a period or periods aggregating less than 90 days during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence. Gains and losses from sales or exchanges of capital assets effected during the taxable year at times other than during such presence in the United States are not to be taken into account for this purpose.

(iii) *Present 90 days or more.*—If he has been present in the United States for a period or periods aggregating 90 days or more during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during that year exceed his losses, allocable to sources within the United States, from sales or exchanges effected at any time during that year. Gains and losses from sales or exchanges effected at any time during the taxable year are to be taken into account for this purpose even though the alien individual is not present in the United States at the time the sales or exchanges are effected.

(iv) *Separate periods to be aggregated.*—In computing the total period of presence in the United States for a taxable year, all separate periods of presence in the United States during the taxable year are to be aggregated.

(v) *Other provisions applicable.*—For the purpose of the computation of the excess of capital gains over capital losses subject to tax under this subparagraph, gains and losses shall, subject to the 90-day rule of section 871(a) (2), be taken into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business within the United States, except that the gains and losses shall be computed without regard to the provisions of section 1202, relating to the deduction for capital gains, and the losses shall be determined without the benefits of the capital loss carryover provided in section 1212. For example, any amount (other than the gains specified in subparagraph (3) of this paragraph) which, under the provisions of subtitle A of the Internal Revenue Code of 1954, is considered to be gain or loss

from the sale or exchange of a capital asset shall be taken into account but only in accordance with this subdivision and subject to the provisions of section 873 and the regulations thereunder. Thus, an amount described in section 631 (b) or (c) which is considered to be loss from the sale or exchange of a capital asset would be taken into account in such manner. Also, for example, no deduction shall be allowed, pursuant to the provisions of section 267, for losses from sales or exchanges of property between related taxpayers.

(vi) *Alternative tax.*—The tax shall be computed under this subparagraph without regard to the alternative tax imposed by section 1201 upon the excess of the net long-term capital gain over the net short-term capital loss.

(vii) *Allowance of losses.*—In computing the tax under this subparagraph losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from sales or exchanges of capital assets.

(viii) *Gains not included.*—The provisions of this subparagraph do not apply to amounts described in section 402(a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets. See subparagraph (3) of this paragraph.

(5) *Deductions allowable.*—For the allowance of deductions in computing the tax under this paragraph, see paragraph (b) 1 of § 1.873-1.

(6) *Credits against tax.*—The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph.

(c) *No United States business; gross income of more than \$15,400.*—

(1) *Imposition of tax.*—Except as otherwise provided by paragraph (e) of this section and subparagraph (4) of this paragraph, a nonresident alien individual within class 2 is, in accordance with the provisions of section 871(b), subject to tax under section 1 or, in the alternative, under section 1201(b) upon the income computed in accordance with this paragraph and received during the taxable year from sources within the United States. In computing the alternative tax under section 1201(b) for this purpose, all amounts constituting, or considered to be, gains and losses from the sale or exchange of capital assets, whether described in paragraph (b) 3 or (4) of this section, shall be taken into account to the extent prescribed by subparagraphs (2) and (3) of this paragraph.

(2) *Gross income.*—For purposes of subparagraph (1) of this paragraph, the gross income shall include only those items of gains, profits, and income which would be taken into account if the tax were being determined in accordance with paragraph (b) of this section, that is, the gross amount of fixed or determinable annual or periodical income determined in accordance with paragraph (b) (2), the full amount of any gain taxable in accordance with paragraph (b) (3), and all other gains (computed without regard to any losses) which are to be taken into account in determining the tax under paragraph (b) (4). For such purposes, all such gains derived from the sale or exchange of capital assets, whether taken into account under para-

graph (b) (3) or (4) of this section, shall be included to the same extent as provided by sections 1201 to 1241, inclusive, and the regulations thereunder.

(3) *Deductions*.—In computing, for purposes of subparagraph (1) of this paragraph, the income subject to tax under section 1 or section 1201(b), there shall be allowed as deductions—

(i) *Capital losses*.—Any loss, allocable to sources within the United States, from the sale or exchange of a capital asset which would be taken into account if the tax were being determined in accordance with paragraph (b) (4) of this section, except that such loss shall be allowed only to the extent provided by sections 1201 to 1241, inclusive, and the regulations thereunder, but without the benefit of the capital loss carryover provided by section 1212;

(ii) *Charitable contributions*.—The deduction for charitable contributions and gifts to the extent allowed by section 170, whether or not connected with income from sources within the United States, but (in accordance with section 873 (c)) only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States; and

(iii) *Other deductions*.—Any other deduction (including the deduction allowed by section 1202 in respect of capital gains) allowed by section 873, but only if, and to the extent that, they are properly allocable to the gross income specified in subparagraph (2) of this paragraph. See also § 1.873-1.

(4) *Minimum tax*.—Notwithstanding the provisions of subparagraph (1) of this paragraph, and except as otherwise provided by paragraph (e) of this section, the tax of a nonresident alien individual within class 2 shall in no case be less than 30 percent of the aggregate of the amounts determined under paragraph (b) (2), (3), and (4) of this section and received during the taxable year from sources within the United States.

(5) *Credits against tax*.—The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 34 (relating to dividends received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph, even though such tax is computed in accordance with subparagraph (4) of this paragraph.

(d) *United States business*.—(1) *Imposition of tax*.—Except as otherwise provided by paragraph (e) of this section, a nonresident alien individual within class 3 is, in accordance with the provisions of section 871 (c), subject to tax under section 1 or, in the alternative, under section 1201(b) upon his taxable income.

(2) *Taxable income*.—For purposes of this paragraph, the taxable income includes only the taxable income from sources within the United States, determined in accordance with the provisions of sections 63(a), 861 to 864, inclusive, 872, and 873, and the regulations thereunder.

(3) *Credits against tax*.—The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 34 (relating to dividends

received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph.

(4) *Inapplicable provisions.*—The provisions of paragraphs (b) and (c) of this section have no application in determining the tax of a nonresident alien individual engaged in trade or business within the United States.

(e) *Treaty income.*—(1) *Definitions.*—For purposes of this paragraph, the term “treaty income” shall be construed to mean the gross income of a nonresident alien individual the tax on which is limited by tax convention. Thus, for example, the term would include dividends derived by such an individual from sources within the United States which, in accordance with a tax convention, are subject to United States tax at a rate not to exceed 15 percent. The term “nontreaty income” shall be construed, for such purposes, to mean the gross income of a nonresident alien individual other than treaty income. In either case the gross income shall be determined in accordance with §§ 1.872-1 and 1.872-2, except that the provisions of section 116 shall be disregarded when determining (i) whether the dividend is within class 1 or class 2 for the purposes of paragraph (a) of this section, (ii) whether the partial tax under subparagraph (3) (i) of this paragraph shall be computed in accordance with section 871 (a) or (b), and (iii) the tax under subparagraph (3) (ii) of this paragraph upon the separate items of treaty income.

(2) *Application of \$15,400 limitation.*—Treaty income shall be taken into account in determining whether a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is within class 1 or class 2 for the purposes of paragraph (a) of this section; however, the tax upon such income shall be separately computed to the extent required by subparagraph (3) of this paragraph.

(3) *Computation of tax.*—If the gross income of a nonresident alien individual within class 1, 2, or 3 consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subdivisions (i) and (ii) of this subparagraph. In no case, however, may the tax liability so determined exceed the tax liability with respect to the taxpayer's entire gross income, determined in accordance with paragraph (b), (c), or (d) of this section as though the tax convention had not come into effect and without reference to the provisions of this paragraph. This subparagraph shall not be construed to deny the credits provided by sections 31, 32, and 6402.

(i) Compute a partial tax upon only the nontreaty income in accordance with section 871 (a), (b), or (c), whichever applies, as determined under paragraph (b), (c), or (d) of this section, and as though the tax convention had not come into effect. To the extent allowed by such paragraph, the credits allowed by sections 34 and 35 shall then be allowed against the tax so computed but only with respect to items included in the nontreaty income. For this purpose the nontreaty income alone shall be used as a basis for determining whether the partial tax shall be computed in accordance with section 871 (a) or (b).

(ii) Compute a tax upon the gross amount of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. Notwithstanding any other provision to the contrary, this tax shall be determined without the allowance of any deduction, credit (other than the credits provided by sections 31, 32, and 6402), or exclusion in respect of any item included in the treaty income.

(4) *Illustration.*—The application of this paragraph may be illustrated by the following examples:

*Example (1).* (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1955 from sources within the United States total gross income of \$125,000, consisting of the following items and computed by taking into account the exclusion granted by section 116(a):

Oil royalties the tax on which is limited by the convention to a rate not to exceed 15 percent .....	\$100,000
Interest the tax on which is limited by the convention to a rate not to exceed 5 percent .....	5,000
Dividends the tax on which is not limited by the convention .....	10,000
Rents the tax on which is not limited by the convention .....	10,000
<b>Total gross income .....</b>	<b>\$125,000</b>

The dividends are assumed to be paid by a domestic corporation not disqualified by section 34(c) or 116(b). There are no allowable deductions, other than the deductions allowed by sections 613 and 873(d). The taxpayer has not engaged in trade or business within the United States or had a permanent establishment therein at any time during the taxable year. Although entitled to do so under the convention, the taxpayer does not elect to be taxed for the taxable year as though he did have a permanent establishment within the United States.

(ii) The tax liability for the taxable year is \$21,792, computed as follows:

Nontreaty gross income .....	\$20,000
Less: Deduction for personal exemption .....	600
<b>Nontreaty taxable income .....</b>	<b>\$19,400</b>
Tax computed under section 1 on nontreaty taxable income .....	\$6,942
Minimum tax prescribed by section 871(b)(3) upon nontreaty gross income (\$20,000 × 30%) .....	6,000
<b>Tax for the taxable year upon nontreaty taxable income, as above....</b>	<b>\$6,942</b>
Less: Credit under section 34 in respect of the nontreaty dividends received, that is, the smallest of the following:	
4% of the dividends included in nontreaty gross income (\$10,000 × 4%) .....	\$400
The tax for the taxable year upon nontreaty taxable income, as above .....	6,942
4% of the nontreaty taxable income for the taxable year (\$19,400 × 4%) .....	776      400
<b>Partial tax computed in accordance with subparagraph (3)(i) .....</b>	<b>\$6,542</b>
Plus: Tax on oil royalties (\$100,000 × 15%) .....	15,000
Tax on interest (\$5,000 × 5%) .....	250
<b>Total .....</b>	<b>\$21,792</b>



*Example (2).* (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1955 from sources within the United States total gross income of \$4,050, consisting of the following items and computed without regard to the exclusion granted by section 116 (a):

Dividends the tax on which is limited by the convention to a rate not to exceed 15 percent .....	\$3,050
Compensation for personal services, the tax on which is not limited by the convention .....	1,000
Total gross income .....	\$4,050

The dividends are assumed to be paid by a domestic corporation not disqualified by section 34(c) or 116(b). The taxpayer was engaged in trade or business within the United States during the taxable year but did not have a permanent establishment therein. Interest expense in the amount of \$2,100 connected with the dividend income was paid by the taxpayer during the taxable year.

(ii) The tax liability for the taxable year is \$208, computed as follows:

Total gross income computed by taking into account the exclusion granted by section 116(a) .....	\$4,000
Less: Deduction for interest expense paid .....	\$2,100
Deduction for personal exemption .....	600
	<u>2,700</u>
Taxable income .....	<u>\$1,300</u>
Tax computed under section 1 on taxable income .....	\$260
Less: Credit under section 34 in respect of the dividends received, that is, the smallest of the following:	
4% of the dividends included in gross income ( $\$3,000 \times 4\%$ ) .....	120
The tax for the taxable year, as above .....	260
4% of taxable income for the taxable year ( $\$1,300 \times 4\%$ ) .....	52
	<u>52</u>
Balance .....	\$208

*Example (3).* (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1955 from sources within the United States total gross income of \$22,000, consisting of the following items:

Compensation for personal services, the tax on which is not limited by the convention .....	\$20,000
Oil royalties the tax on which is limited by the convention to a rate not to exceed 15 percent .....	2,000
Total gross income .....	\$22,000

The taxpayer was engaged in trade or business within the United States during the taxable year but did not have a permanent establishment therein. Although entitled to do so under the convention, the taxpayer does not elect to be taxed for the taxable year as though he did have a permanent establishment within the United States.

There are no allowable deductions, other than the deductions allowed by sections 613 and 873(d).

(ii) The tax liability for the taxable year is \$7,242, computed as follows:

Nontreaty gross income .....	\$20,000
Less: Deduction for personal exemption .....	600
Nontreaty taxable income .....	\$19,400
Tax computed under section 1 on nontreaty taxable income .....	\$6,942
Plus: Tax on oil royalties ( $\$2,000 \times 15\%$ ) .....	300
Total .....	\$7,242

(5) *Exceptions*.—This paragraph shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year or to a nonresident alien individual who, in accordance with a tax convention, is entitled, and does elect, to be subject to tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein. See §§ 1.873-1(b) (3) and 1.876-1.

§ 1.871-8 DEFINITION OF ENGAGING IN TRADE OR BUSINESS WITHIN THE UNITED STATES.—(a) *Personal services*.—As used in sections 861 to 864, inclusive, 871, 881, 882, and 1441 to 1465, inclusive, and the regulations thereunder, the term “engaged in trade or business within the United States” includes the performance of personal services within the United States at any time within the taxable year, but does not include the performance of personal services, (1) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or (2) for an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year whose compensation for such services does not exceed in the aggregate \$3,000. See section 7701(a) (5) and the regulations thereunder for the meaning of “foreign” when applied to a corporation or partnership. As to the source of compensation for personal services, see §§ 1.861-4 and 1.862-1.

(b) *Exchange transactions*.—The term “engaged in trade or business within the United States” when used in such sections does not include the effecting of transactions in the United States in stocks or securities through a resident broker, commission agent, or custodian. Nor does it include the effecting of transactions in the United States in commodities (including hedging transactions) through such a person if (1) the goods are of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, (2) the transaction is of the kind customarily consummated at such place, and (3) the alien, partnership, or corporation, by whom the transactions are effected, has no office or place of business in the United States at any time during the taxable year through which, or by the direction of which, such transactions in commodities are effected. For this purpose the term “commodities”

does not include merchandise in the ordinary channels of commerce. See paragraph (a) (3) of § 1.872-1.

(c) *Trusts*.—Neither the beneficiary nor the grantor of a trust, whether revocable or irrevocable, is deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States.

## § 1.872 STATUTORY PROVISIONS; GROSS INCOME.

### SEC. 872. GROSS INCOME.

(a) *GENERAL RULE*.—In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

(b) *EXCLUSIONS*.—The following items shall not be included in gross income of a nonresident alien individual, and shall be exempt from taxation under this subtitle:

(1) *SHIPS UNDER FOREIGN FLAG*.—Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) *AIRCRAFT OF FOREIGN REGISTRY*.—Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

§ 1.872-1 *GROSS INCOME OF NONRESIDENT ALIEN INDIVIDUALS*.—(a) *General*.—(1) *United States sources*.—The gross income of a nonresident alien individual includes only the gross income from sources within the United States. Except as may otherwise be provided by tax convention, the sources of the income for that purpose shall be determined in accordance with the provisions of sections 861 to 864, inclusive, and the regulations thereunder.

(2) *Change of status*.—Income received by a resident alien from sources without the United States is taxable although he may become a nonresident alien subsequent to its receipt and before the close of the taxable year. Conversely, income received by a nonresident alien from sources without the United States is not taxable although he may become a resident alien subsequent to its receipt and before the close of the taxable year.

(3) *Exchange transactions*.—Even though a nonresident alien individual may not be engaged in trade or business within the United States through the effecting of certain transactions in stocks, securities, or commodities, as described in paragraph (b) of § 1.871-8, nevertheless he shall be required to include in gross income the gains and profits from those transactions to the extent prescribed by § 1.871-7.

(4) *Sales or exchanges of property*.—Amounts constituting, or considered to be, gains from the sale or exchange of capital assets, and profits derived from the sale within the United States of personal property, or from the sale of real property located therein, shall also be included in the gross income of a nonresident alien individual to the extent prescribed by § 1.871-7.

(5) *Exclusions*.—For exclusions from gross income see § 1.872-2.

(b) *No United States business*.—To determine the gross income of a nonresident alien individual who is not engaged in trade or business within the United States at any time during the taxable year, see paragraphs (b) and (c) of § 1.871-7. If that alien is also a bona fide

resident of Puerto Rico during the entire taxable year, see § 1.876-1.

(c) *United States business*.—To determine the gross income of a nonresident alien individual who at any time within the taxable year is engaged in trade or business within the United States, see paragraph (d) of § 1.871-7. If that alien is also a bona fide resident of Puerto Rico during the entire taxable year, see § 1.876-1.

§ 1.872-2 EXCLUSIONS FROM GROSS INCOME OF NONRESIDENT ALIEN INDIVIDUALS.—(a) *Earnings of foreign ships or aircraft*.—(1) *Basic rule*.—So much of the income from sources within the United States of a nonresident alien individual as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*.—(i) *Ships*.—A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft*.—A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Tax conventions*.—Income of any kind which is exempt from United States tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a nonresident alien individual. Income on which the tax is limited by tax convention shall, however, be included in the gross income of such an individual if it is not otherwise excluded from gross income. See §§ 1.871-7 (e) and 1.894-1.

(c) *Other exclusions*.—Income which is from sources without the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, or under the provisions of an applicable tax convention, shall not be included in the gross income of a nonresident alien individual. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Internal Revenue Code of 1954.

## § 1.873 STATUTORY PROVISIONS; DEDUCTIONS.

### SEC. 873. DEDUCTIONS.

(a) *GENERAL RULE*.—In the case of a nonresident alien individual the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper

apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(b) **LOSSES.**—

(1) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165(c)(2) (relating to losses) shall be allowed whether or not connected with income from sources within the United States, but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

(2) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States.

(c) **CHARITABLE CONTRIBUTIONS.**—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(d) **PERSONAL EXEMPTION.**—In the case of a nonresident alien individual who is not a resident of a contiguous country, only one exemption under section 151 shall be allowed as a deduction.

(e) **STANDARD DEDUCTION.**—For disallowance of standard deduction, see section 142(b)(1).

§ 1.873-1 **DEDUCTIONS ALLOWED NONRESIDENT ALIEN INDIVIDUALS.**—

(a) *General provisions.*—(1) *Allocation of deductions.*—In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. No deduction shall be allowed in respect of any item, or portion thereof, which is not connected with income from such sources. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in sections 861 to 864, inclusive, and the regulations thereunder, except as may otherwise be provided by tax convention. Thus, from the items of gross income specifically from sources within the United States and from the items allocated thereto under the provisions of section 863(a), there shall be deducted (i) the expenses, losses, and other deductions which are connected with those items of income and are properly apportioned or allocated thereto, and (ii) a ratable part of any other expenses, losses, or deductions which are connected with those items of income but cannot definitely be allocated to some item or class of gross income. The ratable part shall be based upon the ratio of gross income from sources within the United States to the total gross income. See §§ 1.861-8 and 1.863-1. In the case of income partly from within and partly from without the United States the expenses, losses, and other deductions connected with income from sources within the United States shall also be deducted in the manner prescribed by §§ 1.863-2 through 1.863-5 in order to ascertain under section 863 the portion of the taxable income attributable to sources within the United States.

(2) *Personal exemptions.*—The deductions for the personal exemptions allowed by section 151 or 642(b) shall not be taken into account for purposes of subparagraph (1) of this paragraph but shall be

allowed to the extent provided by paragraphs (b) and (c) of this section.

(3) *Adjusted gross income.*—The adjusted gross income of a non-resident alien individual shall be the gross income from sources within the United States, determined in accordance with § 1.871-7, minus the deductions prescribed by section 62 to the extent such deductions are allowed under this section in computing taxable income.

(4) *Standard deduction.*—The standard deduction shall not be allowed in computing the taxable income of a nonresident alien individual. See section 142(b)(1) and the regulations thereunder.

(5) *Exempt income.*—No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(b) *No United States business.*—(1) *Income of not more than \$15,400.*—(i) *Deduction for losses only.*—A nonresident alien individual within class 1 shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b) (4) (vii) of § 1.871-7. Thus, an individual within this class shall not be allowed any deductions for the personal exemptions otherwise allowed by section 151 or 642(b).

(ii) *Source of losses.*—Notwithstanding the provisions of section 873(b)(1), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (b) (4) (i) of § 1.871-7.

(2) *Aggregate more than \$15,400.*—(i) *Deductions allowed.*—In computing the income subject to tax under section 1 or section 1201(b), a nonresident alien individual within class 2 shall be allowed deductions to the extent prescribed by paragraph (c) (3) of § 1.871-7, but subject to the limitations of this section. For this purpose, the deduction for the personal exemptions shall be allowed in accordance with subdivision (iii) of this subparagraph.

(ii) *Deductions disallowed.*—In computing the minimum tax prescribed by section 871(b)(3), that individual shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b) (4) (vii) of § 1.871-7. For this purpose, the deductions for the personal exemptions shall not be allowed. See paragraph (c) (4) of § 1.871-7.

(iii) *Personal exemptions.*—When the deductions for personal exemptions are allowed under this subparagraph, only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

(iv) *Source of losses.*—Notwithstanding the provisions of section 873(b), losses from sales or exchanges of capital assets shall be al-

lowed under this subparagraph only if allocable to sources within the United States. See paragraph (c) (3) (i) of § 1.871-7.

(3) *Election to be taxed on a net basis.*—Notwithstanding the other provisions of this paragraph, a nonresident alien individual within class 1 or 2 shall be allowed the deductions allowed by paragraph (c) of this section, if pursuant to a tax convention he is entitled, and does elect, to be subject to United States tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein.

(c) *United States business.*—(1) *Deductions in general.*—For purposes of computing the income subject to tax, a nonresident alien individual within class 3 shall be allowed deductions to the extent prescribed by paragraph (d) of § 1.871-7, but subject to the limitations of this section. For this purpose, the deductions for the personal exemptions shall be allowed in accordance with subparagraph (3) of this paragraph.

(2) *Special deductions.*—Notwithstanding the rule of source prescribed in paragraph (a) of this section, an individual within class 3 shall be allowed the following deductions whether or not they are connected with income from sources within the United States:

(i) *Losses on transactions for profit.*—Any loss sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business, shall be allowed to the extent allowed by section 165(c) (2), but only if and to the extent that the profit, if the transaction had resulted in a profit, would be taxable to such individual. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861-8 and 1.863-1, when the profit from the transaction, if it had resulted in a profit, would, under the provisions of section 861(a) or 863(a), have been taxable in full as income from sources within the United States; but shall be deducted under the provisions of § 1.863-3 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

(ii) *Casualty losses.*—Any loss of property not connected with a trade or business, sustained during the taxable year and not compensated for by insurance or otherwise, if the loss arises from fire, storm, shipwreck, or other casualty, or from theft, shall be allowed to the extent allowed by section 165(c) (3), but only if the loss is of property within the United States. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861-8 and 1.863-1, from the items of gross income specified under sections 861(a) and 863(a) as being derived in full from sources within the United States; but, if greater than the sum of those items, the unabsorbed loss shall be deducted from the income apportioned under the provisions of § 1.863-3 to sources within the United States.

(iii) *Charitable contributions.*—The deduction for charitable contributions and gifts, to the extent allowed by section 170, shall be allowed under this subparagraph, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(3) *Personal exemptions.*—Only one exemption under section 151 § 1.873-1(b) (3)

shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

## § 1.874 STATUTORY PROVISIONS; ALLOWANCE OF DEDUCTIONS AND CREDITS.

### SEC. 874. ALLOWANCE OF DEDUCTIONS AND CREDITS.—

(a) **RETURN PREREQUISITE TO ALLOWANCE.**—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed a true and accurate return of his total income received from all sources in the United States, in the manner prescribed in subtitle F (sec. 6001 and following, relating to procedure and administration), including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This subsection shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at the source.

(b) **TAX WITHHELD AT SOURCE.**—The benefit of the deduction for exemptions under section 151 may, in the discretion of the Secretary or his delegate, and under regulations prescribed by the Secretary or his delegate, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

(c) **FOREIGN TAX CREDIT NOT ALLOWED.**—A nonresident alien individual shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

§ 1.874-1 **ALLOWANCE OF DEDUCTIONS AND CREDITS TO NONRESIDENT ALIEN INDIVIDUALS.**—(a) *Return required.*—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him with respect to the income tax, only if he files or causes to be filed with the district director (or, if applicable, with the Director of International Operations), in accordance with section 6012 and the regulations thereunder, a true and accurate return of his total income received from all sources within the United States. This paragraph shall not be construed, however, to deny the credits provided by sections 31 and 32.

(b) *Tax on gross income.*—If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.871-7 but without regard to any deductions otherwise allowable, and the only credits allowable against the tax so computed shall be those allowed by sections 31 and 32. This paragraph shall apply even though the tax determined, in accordance with § 1.871-7 has been fully satisfied at the source. See also § 1.872-1.

(c) *Return by district director.*—If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed by him or on his behalf, the district director (or, if applicable, the Director of International Operations) shall (1) cause a return of income to be made, (2) include therein the income described in § 1.871-7 of that individual from all sources concerning which he has



information, and (3) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for deductions or credits (other than the credits provided by sections 31 and 32).

(d) *Alien resident of Puerto Rico*.—This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See § 1.876-1.

#### § 1.875 STATUTORY PROVISIONS; PARTNERSHIPS.

##### SEC. 875. PARTNERSHIPS.

For purposes of this subtitle, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged.

§ 1.875-1 PARTNERSHIPS.—Whether a nonresident alien individual who is a member of a partnership is taxable in accordance with subsection (a), (b), or (c) of section 871 may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 871 (a) or (b), as the case may be, depending on whether or not he receives during the taxable year an aggregate of more than \$15,400 gross income described in section 871(a), if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 871(c). For definition of what the term “partnership” includes, see section 7701(a) (2) and the regulations thereunder. The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See § 1.871-8.

#### § 1.876 STATUTORY PROVISIONS; ALIEN RESIDENTS OF PUERTO RICO.

##### SEC. 876. ALIEN RESIDENTS OF PUERTO RICO.

(a) NO APPLICATION TO CERTAIN ALIEN RESIDENTS OF PUERTO RICO.—This subpart shall not apply to an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, and such alien shall be subject to the tax imposed by section 1.

(b) CROSS REFERENCE.—For exclusion from gross income of income derived from sources within Puerto Rico, see section 933.

§ 1.876-1 ALIEN RESIDENTS OF PUERTO RICO.—(a) *General*.—A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in accordance with the provisions of section 876, subject to tax under section 1 or, in the alternative, under section 1201(b) in generally the same manner as in the case of an alien resident of the United States. See §§ 1.1-1(b) and 1.871-1. The tax is imposed upon the taxable income of such a resident of Puerto Rico, determined in accordance with section 63(a) and the regulations thereunder, from sources both within and without the United States, except that under the provisions of section 933 income derived from sources within Puerto Rico (other than amounts received for services performed as an employee of the United States

§ 1.874-1(d)

or any agency thereof) is excluded from gross income. For determining the form of return to be used by such an individual, see section 6012 and the regulations thereunder.

(b) *Exceptions.*—Though subject to the tax imposed by section 1, a nonresident alien individual who is a bona fide resident of Puerto Rico during his entire taxable year shall nevertheless be treated as a nonresident alien for the purpose of many provisions of the Internal Revenue Code of 1954 relating to nonresident alien individuals. Thus, for example, such a resident of Puerto Rico is not allowed to compute his tax in accordance with the optional tax table (section 4(d)(1)); is not allowed the standard deduction (section 142(b)(1)); is not allowed a deduction for a “dependent” who is a resident of Puerto Rico unless the dependent is a citizen of the United States (section 152(b)(3)); is subject to withholding of tax at source under chapter 3 (sections 1441(d) and 1451(e)); is generally not subject to the collection of income tax at source on wages (section 3401(a)(6)); is not allowed to make a joint return or a joint declaration of estimated tax (sections 6013(a)(1) and 6015(b)); must pay his estimated tax on or before the 15th day of the fourth month of the taxable year (sections 6015(a), 6073(a), and 6153(a)(1)); and must pay his income tax on or before the 15th day of the 6th month following the close of the taxable year (sections 6072(c) and 6151(a)).

(c) *Credits against tax.*—The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to taxes of foreign countries), section 34 (relating to dividends received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this section. No credit shall be allowed under section 37 in respect of retirement income.

## § 1.877 STATUTORY PROVISIONS; CERTAIN FOREIGN EXEMPT ORGANIZATIONS.

### SEC. 877. FOREIGN EDUCATIONAL, CHARITABLE, AND CERTAIN OTHER EXEMPT ORGANIZATIONS.

For special provisions relating to unrelated business income of foreign educational, charitable, and other exempt trusts, see section 512(a).

#### FOREIGN CORPORATIONS

## § 1.881 STATUTORY PROVISIONS; TAX ON FOREIGN CORPORATIONS NOT ENGAGED IN BUSINESS IN THE UNITED STATES.

### SEC. 881. TAX ON FOREIGN CORPORATIONS NOT ENGAGED IN BUSINESS IN UNITED STATES.

(a) *IMPOSITION OF TAX.*—In the case of every foreign corporation not engaged in trade or business within the United States, there is hereby imposed for each taxable year, in lieu of the taxes imposed by section 11, a tax of 30 percent of the amount received from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 631(b) and (c) which are considered to be gains from the sale or exchange of capital assets).

(b) DOUBLING OF TAX.—For doubling of tax on corporations of certain foreign countries, see section 891.

§ 1.881-1 TAXATION OF FOREIGN CORPORATIONS.—(a) *Classes of foreign corporations.*—For purposes of the income tax, foreign corporations are divided into two classes, namely, nonresident foreign corporations and resident foreign corporations. A nonresident foreign corporation is a foreign corporation which is not engaged in trade or business within the United States at any time during the taxable year. A resident foreign corporation is a foreign corporation which, at some time during the taxable year, is engaged in trade or business within the United States. See also section 7701 and the regulations thereunder.

(b) *Manner of taxing.*—A foreign corporation, whether resident or nonresident, is taxable only on income derived from sources within the United States, to the extent indicated in § 1.881-2 or § 1.882-1.

(c) *Meaning of terms.*—For the meaning of the term “engaged in trade or business within the United States”, as used in this section, see § 1.871-8. For the definition of the term “foreign corporation”, see section 7701(a) (3) and (5) and the regulations thereunder.

(d) *Corporations included as foreign.*—The following corporations shall be included as foreign corporations for purposes of this section :

(1) A foreign life insurance company not carrying on an insurance business within the United States, as described in section 816(b) (section 807(b) in the case of taxable years beginning before January 1, 1955) ;

(2) A foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States, as described in section 821(d) ; and

(3) A foreign insurance company (other than a life or mutual insurance company), a foreign mutual marine insurance company, and a foreign mutual fire insurance company, not carrying on an insurance business within the United States, as described in section 831 (b).

(e) *Other provisions applicable to foreign corporations.*—(1) *Insurance companies.*—For the taxation of foreign insurance companies carrying on an insurance business within the United States, see sections 816(a) (section 807(a) in the case of taxable years beginning before January 1, 1955), 822(e), and 832(d), and the regulations thereunder.

(2) *Accumulated earnings tax.*—For the imposition of the accumulated earnings tax upon the accumulated taxable income of a foreign corporation, whether resident or nonresident, formed or availed of for tax avoidance purposes, see section 532 and the regulations thereunder.

(3) *Personal holding company tax.*—For the imposition of the personal holding company tax upon the undistributed personal holding company income of a foreign corporation, whether resident or nonresident, see sections 541 and 545 and the regulations thereunder.

(4) *Foreign personal holding companies.*—For the mandatory inclusion in the gross income of the United States shareholders of the undistributed foreign personal holding company income of a foreign

personal holding company, see section 551 and the regulations thereunder.

§ 1.881-2 **TAX ON NONRESIDENT FOREIGN CORPORATIONS.**—(a) *Imposition of tax.*—Except as otherwise provided by paragraph (f) of this section, a nonresident foreign corporation is not subject to the tax imposed by section 11 or 1201(a) but, pursuant to the provisions of section 881(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b) and (c) of this section and received during the taxable year from sources within the United States. For this purpose the source of the income shall be determined in accordance with the provisions of § 1.882-2. For the purposes of section 881(a), “amount received” means “gross income”.

(b) *Fixed or determinable annual or periodical income.*—The tax of 30 percent applies to the gross amount received as fixed or determinable annual or periodical gains, profits, and income. Specific items of fixed or determinable annual or periodical income are enumerated in section 881(a) as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax as, for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441-2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income, see section 306(f) and the regulations thereunder.

(c) *Amounts considered to be capital gains.*—The tax of 30 percent also applies, pursuant to the provisions of section 881(a), to amounts received during the taxable year from sources within the United States which are described in section 631(b) and (c) and are considered to be gains from the sale or exchange of capital assets. Thus, the tax applies to gain recognized under specified circumstances on the disposal of timber and coal and considered in accordance with section 1231 to be gain from the sale or exchange of a capital asset.

(d) *Losses and other deductions.*—In computing the income subject to tax under this section no deduction shall be allowed for any loss sustained during the taxable year, even though the loss is taken into account under section 1231 in determining whether the gain is considered to be gain from the sale or exchange of a capital asset. For the general disallowance of deductions in computing the tax under this section, see paragraph (a) (1) of § 1.882-3.

(e) *Credit against tax.*—The credit allowed by section 32 (relating to tax withheld at source on foreign corporations) shall be allowed against the tax computed in accordance with this section.

(f) *Treaty income.*—If the gross income of a nonresident foreign corporation consists of both treaty and nontreaty income, the tax liability for the taxable year shall be determined in a manner consistent with that prescribed by paragraph (e) of § 1.871-7 in the case of a nonresident alien individual.

§ 1.882 STATUTORY PROVISIONS; TAX ON RESIDENT FOREIGN CORPORATIONS.

SEC. 882. TAX ON RESIDENT FOREIGN CORPORATIONS.

(a) IMPOSITION OF TAX.—A foreign corporation engaged in trade or business within the United States shall be taxable as provided in section 11.

(b) GROSS INCOME.—In the case of a foreign corporation, gross income includes only the gross income from sources within the United States.

(c) ALLOWANCE OF DEDUCTIONS AND CREDITS.—

(1) DEDUCTIONS ALLOWED ONLY IF RETURN FILED.—A foreign corporation shall receive the benefit of the deductions allowed to it in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of its total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions.

(2) ALLOCATION OF DEDUCTIONS.—In the case of a foreign corporation the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(3) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States.

(4) FOREIGN TAX CREDIT.—Foreign corporations shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(d) RETURNS OF TAX BY AGENT.—If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent.

§ 1.882-1 TAX ON RESIDENT FOREIGN CORPORATIONS.—(a) *General*.—(1) *Imposition of tax*.—Except as otherwise provided by subparagraph (7) of this paragraph, a resident foreign corporation is, in accordance with section 882 (a), subject to tax as prescribed by paragraphs (b) and (c) of this section or, in the alternative, to the tax imposed by section 1201(a).

(2) *Taxable income*.—For purposes of this section, the taxable income of a resident foreign corporation includes only the taxable income from sources within the United States, determined in accordance with the provisions of sections 63 (a), 861 to 864, inclusive, 882, and 883, and the regulations thereunder.

(3) *Credit against tax*.—The credit allowed by section 32 (relating to tax withheld at source on foreign corporations) shall be allowed against the tax computed in accordance with this section.

(4) *Changes in tax rate*.—For provisions respecting the effect of any change in rate of tax during the taxable year, see section 21 and the regulations thereunder.

(5) *Declarations of estimated tax*.—Every foreign corporation which for its taxable year expects to be subject to tax under this section shall make a declaration of estimated tax in accordance with the provisions of section 6016 and the regulations thereunder.

(6) *Consolidated returns*.—Except in the case of certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of such country as

to title and operation of property, a foreign corporation is not an includible corporation for purposes of the privilege of making a consolidated return by an affiliated group of corporations. See § 1.1502-2 (b) (1) and (3).

(7) *Treaty income*.—If the gross income of a resident foreign corporation consists of both treaty and nontreaty income, the tax liability for the taxable year shall be determined in a manner consistent with that prescribed by paragraph (e) of § 1.871-7 in the case of a non-resident alien individual.

(b) *Normal tax*.—A resident foreign corporation is liable to the normal tax imposed by section 11 (b). See that section and the regulations thereunder.

(c) *Surtax*.—A resident foreign corporation is also liable to the surtax imposed by section 11 (c). See that section and the regulations thereunder.

§ 1.882-2 GROSS INCOME OF FOREIGN CORPORATIONS.—(a) *United States sources*.—The gross income of a foreign corporation, whether resident or nonresident, includes only the gross income from sources within the United States. Except as may otherwise be provided by tax convention, the sources of the income for that purpose shall be determined in accordance with the provisions of section 861 to 864, inclusive, and the regulations thereunder.

(b) *Nonresident foreign corporations*.—The gross income of a non-resident foreign corporation consists only of the items of income specified in section 881 (a) and described in § 1.881-2.

(c) *Resident foreign corporations*.—(1) *Gross income not limited to specified items*.—The gross income of a resident foreign corporation is not limited to the items of income specified in section 881 (a) but includes every item of gross income which, in accordance with paragraph (a) of this section, is treated as gross income from sources within the United States. See also paragraph (a) (2) of § 1.882-1.

(2) *Income from sale of property*.—The gross income of a resident foreign corporation shall, subject to the provisions of paragraph (a) of this section, include gains derived from the sale or exchange of capital assets, gains from hedging transactions, and profits derived from the sale within the United States of personal property or from the sale of real property located therein.

(3) *Exchange transactions*.—Even though a foreign corporation may not be engaged in trade or business within the United States through the effecting of certain transactions in stocks, securities, or commodities, as described in paragraph (b) of § 1.871-8, nevertheless it shall, subject to the provisions of paragraph (a) of this section, be required to include in gross income the gains and profits from those transactions if at any time during the taxable year it has otherwise engaged in trade or business within the United States.

(d) *Exclusions*.—For exclusions from gross income see § 1.883-1.

1.882-3 DEDUCTIONS ALLOWED FOREIGN CORPORATIONS.—(a) *Non-resident foreign corporations*.—(1) *General*.—For purposes of computing the tax imposed by section 881 (a) and described in § 1.881-2, a nonresident foreign corporation shall not be allowed any deductions,

since the tax is imposed upon the gross amount received from sources within the United States.

(2) *Election to be taxed on a net basis.*—Notwithstanding the provisions of subparagraph (1) of this paragraph, a nonresident foreign corporation shall be allowed the deductions allowed by paragraph (b) of this section, if pursuant to a tax convention it is entitled, and does elect, to be subject to United States tax on a net basis as though it were engaged in trade or business within the United States through a permanent establishment situated therein.

(b) *Resident foreign corporations.*—(1) *General.*—For purposes of computing the income subject to tax, a resident foreign corporation shall be allowed deductions to the extent prescribed by paragraph (a) (2) of § 1.882-1, but subject to the limitations of this paragraph.

(2) *Allocation of deductions.*—In computing the taxable income of a resident foreign corporation the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined in the same manner as provided in paragraph (a) (1) of § 1.873-1 with respect to nonresident alien individuals.

(3) *Special deductions.*—The special deductions allowed by section 241 (relating to the deductions for partially tax-exempt interest, dividends received, etc.) in the case of a corporation shall be taken into account for purposes of subparagraph (2) of this paragraph. Thus, these deductions shall be allowed only in respect of amounts included in gross income pursuant to § 1.882-2.

(4) *Exempt income.*—No deduction shall be allowed under this paragraph for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(5) *Charitable contributions.*—Notwithstanding the rule of source prescribed in subparagraph (2) of this paragraph, a resident foreign corporation shall be allowed the deduction for charitable contributions and gifts, to the extent allowed by section 170, whether or not the deduction is connected with income from sources within the United States.

#### § 1.882-4 ALLOWANCE OF DEDUCTIONS TO FOREIGN CORPORATIONS.—

(a) *Nonresident foreign corporations.*—As indicated in § 1.882-3, a nonresident foreign corporation is not allowed any deductions, whether or not a return of income is filed. The deductions allowed such a corporation electing under a tax convention to be subject to tax on a net basis shall be obtained by filing a return of income in the manner prescribed in the regulations under the tax convention. See paragraph (a) (2) of § 1.882-3.

(b) *Resident foreign corporations.*—(1) *Return necessary.*—A resident foreign corporation shall receive the benefit of the deductions allowed to it with respect to the income tax, only if it files or causes to be filed with the district director, in accordance with section 6012 and the regulations thereunder, a true and accurate return of its total income received from all sources within the United States.

#### § 1.882-3(a) (2)

(2) *Tax on gross income.*—If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.882-1 but without regard to any deductions otherwise allowable.

(3) *Return by district director.*—If a resident foreign corporation has various sources of income within the United States and a return of income has not been filed by it or on its behalf, the district director shall (i) cause a return of income to be made, (ii) include therein the income described in § 1.882-1 of that corporation from all sources concerning which he has information, and (iii) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions.

## § 1.883 STATUTORY PROVISIONS; EXCLUSIONS FROM GROSS INCOME.

### SEC. 883. EXCLUSIONS FROM GROSS INCOME.

The following items shall not be included in gross income of a foreign corporation, and shall be exempt from taxation under this subtitle:

(1) *SHIPS UNDER FOREIGN FLAG.*—Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) *AIRCRAFT OF FOREIGN REGISTRY.*—Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

§ 1.883-1 EXCLUSIONS FROM GROSS INCOME OF FOREIGN CORPORATIONS.—(a) *Earnings of foreign ships or aircraft.*—(1) *Basic rule.*—So much of the income from sources within the United States of a foreign corporation as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption.*—(i) *Ships.*—A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.*—A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Tax conventions.*—Income of any kind which is exempt from United States tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the



gross income of a foreign corporation. Income on which the tax is limited by tax convention shall, however, be included in the gross income of such a corporation if it is not otherwise excluded from gross income. See §§ 1.881-2(f), 1.882-1(a) (7), and 1.894-1.

(c) *Other exclusions.*—Income which is from sources without the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, or under the provisions of an applicable tax convention, shall not be included in the gross income of a foreign corporation. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Internal Revenue Code of 1954.

## § 1.884 STATUTORY PROVISIONS; CROSS REFERENCES.

### SEC. 884. CROSS REFERENCES.

(1) For withholding at source of tax on income of foreign corporations, see section 1442.

(2) For rules applicable in determining whether any foreign corporation is engaged in trade or business within the United States, see section 871(c).

(3) For special provisions relating to foreign insurance companies, see subchapter L (sec. 801 and following).

(4) For special provisions relating to unrelated business income of foreign educational, charitable, and certain other exempt organizations, see section 512(a).

### MISCELLANEOUS PROVISIONS

## § 1.891 STATUTORY PROVISIONS; DOUBLING OF RATES OF TAX ON CITIZENS AND CORPORATIONS OF CERTAIN FOREIGN COUNTRIES.

### SEC. 891. DOUBLING OF RATES OF TAX ON CITIZENS AND CORPORATIONS OF CERTAIN FOREIGN COUNTRIES.

Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 811, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

[Sec. 891 as amended in respect of taxable years beginning after December 31, 1954, by sec. 5 (6), Life Insurance Company Tax Act for 1955]

§ 1.892 STATUTORY PROVISIONS; INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

SEC. 892. INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

§ 1.892-1 INCOME OF FOREIGN GOVERNMENTS AND INTERNATIONAL ORGANIZATIONS.—(a) *Foreign governments*.—The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities which are not actually owned by, but are loaned to, such foreign governments is subject to tax.

(b) *International organizations*.—(1) *Exempt from tax*.—Subject to the provisions of section 1 of the International Organizations Immunities Act (the provisions of which section are set forth in paragraph (b) (3) of § 1.893-1), the income of an international organization (as defined in section 7701(a) (18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(2) *Income received prior to Presidential designation*.—An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an Act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

§ 1.893 STATUTORY PROVISIONS; COMPENSATION OF EMPLOYEES OF FOREIGN GOVERNMENTS OR INTERNATIONAL ORGANIZATIONS.

SEC. 893. COMPENSATION OF EMPLOYEES OF FOREIGN GOVERNMENTS OR INTERNATIONAL ORGANIZATIONS.

(a) *RULE FOR EXCLUSION*.—Wages, fees, or salary of any employee of a foreign government or of an international organization (including a consular or other officer, or a non-diplomatic representative), received as compensation for official services to such government or international organization shall not be included in gross income and shall be exempt from taxation under this subtitle if—

(1) such employee is not a citizen of the United States, or is a citizen

of the Republic of the Philippines (whether or not a citizen of the United States); and

(2) in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

(3) in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.

(b) **CERTIFICATE BY SECRETARY OF STATE.**—The Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

§ 1.893-1 **COMPENSATION OF EMPLOYEES OF FOREIGN GOVERNMENTS OR INTERNATIONAL ORGANIZATIONS.**—(a) *Employees of foreign governments.*—(1) *Exempt from tax.*—Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act, all employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States, or are citizens of the Republic of the Philippines (whether or not citizens of the United States), are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in that foreign country and (ii) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in that foreign country.

(2) *Certificate by Secretary of State.*—Section 893(b) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

(3) *Items not exempt.*—The income received by employees of foreign governments from sources other than their salaries, fees, or wages, referred to in subparagraph (1) of this paragraph, is subject to Federal income tax.

(4) *Immigration and Nationality Act.*—Section 247(b) of the Immigration and Nationality Act provides as follows:

(b) The adjustment of status required by subsection (a) [of section 247 of the Immigration and Nationality Act] shall not be applicable in the case of any alien who requests that he be permitted to retain his status as an immigrant and who, in such form as the Attorney General may require, executes and files with the Attorney General a written waiver of all rights, privileges, exemptions, and immunities under any law or any executive order which would otherwise accrue to him because of the acquisition of an occupational status entitling him to a nonimmigrant status under paragraph (15)(A), (15)(E), or (15)(G) of section 101(a).

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(5) *Effect of waiver.*—An employee of a foreign government who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Internal Revenue Code of 1954. As a consequence, that exemption does not apply to income received by that alien after the date of filing of the waiver.

(6) *Citizens of the United States.*—The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of a foreign government is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(b) *Employees of international organizations.*—(1) *Exempt from tax.*—Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act, and subject to the provisions of sections 1, 8, and 9 of the International Organizations Immunities Act, wages, fees, or salary of any officer or employee of an international organization (as defined in section 7701(a)(18)) received as compensation for official services to that international organization is exempt from Federal income tax, if that officer or employee (i) is not a citizen of the United States or (ii) is a citizen of the Republic of the Philippines (whether or not a citizen of the United States).

(2) *Income earned prior to executive action.*—An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to, and accepted by, the Secretary of State as an officer or employee of that organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of that organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by that individual, either prior to the date of the issuance of the Executive order, or prior to the date of the acceptance or designation by the Secretary of State, for official services to that organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time the compensation is earned, and (iii) the individual is an officer or employee of that organization at that time.

(3) *International Organizations Immunities Act.*—Sections 1, 8, and 9 of the International Organizations Immunities Act provide in part as follows:

SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term "international organization" means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any

such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a \* \* \* officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective \* \* \* officer, or employee; \* \* \*.

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the \* \* \* international organization concerned \* \* \*, and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees \* \* \* provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided*, That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

(4) *Effect of waiver*.—An officer or employee of an international organization who executes and files with the Attorney General the waiver provided for in section 247 (b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Internal Revenue Code of 1954. As a consequence, that exemption does not apply to income received by that individual after the date of filing of the waiver.

(5) *Citizens of the United States*.—The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of an international organization is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(c) *Tax conventions, consular conventions, and international agreements*.—(1) *Exemption dependent upon internal revenue laws*.—A tax convention or consular convention between the United States and a foreign country, which provides that the United States may include in the tax base of its residents all income taxable under the internal revenue laws, and which makes no specific exception for the income of the employees of that foreign government, does not provide any exemption (with respect to residents of the United States) beyond that which is provided by the internal revenue laws. Accordingly,

the effect of the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act by an employee of a foreign government which is a party to such a convention is to subject the employee to tax to the same extent as provided in paragraph (a) (5) of this section with respect to the waiver of exemption under section 893.

(2) *Exemption not dependent upon internal revenue laws.*—If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article IX, section 9(b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9(b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

#### § 1.894 STATUTORY PROVISIONS; INCOME EXEMPT UNDER TREATY.

##### SEC. 894. INCOME EXEMPT UNDER TREATY.

Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

§ 1.894-1 INCOME EXEMPT UNDER TREATY.—Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from income tax. A tax convention shall be considered as a treaty for this purpose. See §§ 1.871-7(e), 1.881-2(f), or 1.882-1(a)(7) for the manner of computing the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is limited by tax convention.

#### INCOME FROM SOURCES WITHOUT THE UNITED STATES

##### FOREIGN TAX CREDIT

#### § 1.901 STATUTORY PROVISIONS; TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES; ALLOWANCE OF CREDIT.

##### SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) ALLOWANCE OF CREDIT.—If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under section 902. Such choice may be made or changed at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax against which the credit is allowable. The credit shall not be allowed against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating

to war loss recoveries), or against the personal holding company tax imposed by section 541.

(b) AMOUNT ALLOWED.—Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) CITIZENS AND DOMESTIC CORPORATIONS.—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) RESIDENT OF THE UNITED STATES OR PUERTO RICO.—In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) ALIEN RESIDENT OF THE UNITED STATES OR PUERTO RICO.—In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) PARTNERSHIPS AND ESTATES.—In the case of any individual described in paragraph (1), (2), or (3), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(c) CORPORATIONS TREATED AS FOREIGN.—For purposes of this subpart, the following corporations shall be treated as foreign corporations:

(1) a corporation entitled to the benefits of section 931, by reason of receiving a large percentage of its gross income from sources within a possession of the United States; and

(2) a corporation organized under the China Trade Act, 1922 (15 U.S.C., chapter 4), and entitled to the deduction provided in section 941.

(d) CROSS REFERENCE.—

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see section 164.

(2) For right of each partner to make election under this section, see section 703(b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a)(2).

§ 1.901-1 ALLOWANCE OF CREDIT FOR TAXES.—(a) *In general.*—Citizens of the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in the following subparagraphs:

(1) *Citizen of the United States.*—A citizen of the United States, whether resident or nonresident, may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (ii) his share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(2) *Domestic corporation.*—A domestic corporation may claim a credit for (i) the amount of any income, war profits, and excess

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profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (ii) the taxes deemed to have been paid under section 902.

(3) *Alien resident of the United States or Puerto Rico.*—An alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any possession of the United States;

(ii) The amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(iii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary, paid or accrued during the taxable year,

(a) To any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country, or

(b) To any possession of the United States, as the case may be.

(b) *Foreign countries which satisfy the similar credit requirement.*—(1) *Taxes of foreign country of which alien resident is citizen or subject.*—A foreign country of which an alien resident is a citizen or subject allows a similar credit, within the meaning of section 901

(b) (3), to a United States citizen residing in such country either—

(i) If such country allows him a credit against its income taxes for the amount of income taxes paid or accrued to the United States; or

(ii) If, in imposing such taxes, such country exempts from taxation the income received by him from sources within the United States (as determined under sections 861 through 864).

(2) *Taxes of foreign country other than one of which alien resident is citizen or subject.*—An alien resident of the United States may claim a credit for income taxes paid or accrued by him to a foreign country other than the one of which he is a citizen or subject if the country of which he is a citizen or subject either—

(i) Allows a credit to a United States citizen residing therein for income taxes paid or accrued by him to such other foreign country; or

(ii) In imposing its income taxes, exempts from taxation the income of a United States citizen residing therein from sources within such other foreign country.

(c) *Deduction denied if credit claimed.*—If a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to income, war profits, and excess profits taxes paid or accrued in such taxable year to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income in such taxable year or any succeeding taxable year. See section 164(b) (6).

(d) *Period during which election can be made or changed.*—The



taxpayer may, with respect to a particular taxable year, claim the benefits of section 901 (or change such choice if previously made) at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax against which the credit is allowable. See section 6511 (a) and (d) (3).

(e) *Joint return*.—In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) *Taxes against which credit not allowed*.—The credit for taxes shall be allowed only against the tax imposed by chapter 1 but it shall not be allowed against the following taxes imposed under that chapter:

- (1) The tax on accumulated earnings imposed by section 531;
- (2) The personal holding company tax imposed by section 541; and
- (3) The additional tax relating to war loss recoveries imposed by section 1333.

(g) *Taxpayers to whom credit not allowed*.—Among those to whom the credit for taxes is not allowed are the following:

- (1) A foreign corporation (see section 882(c) (4));
- (2) A China Trade Act corporation (see section 942);
- (3) A citizen or domestic corporation entitled to the benefits of the exemption provided by section 931 for income from possessions of the United States (see section 931(g));
- (4) A nonresident alien, other than an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year (see sections 874 (c) and 901 (b) (3));
- (5) A citizen of a possession of the United States (except Puerto Rico) who is not otherwise a citizen of the United States and who is not a resident of the United States and persons who are inhabitants of the Virgin Islands (see section 932).

(h) *Taxpayers denied credit in a particular taxable year*.—Taxpayers who are denied the credit for taxes for particular taxable years are the following:

- (1) An individual who elects to pay the optional tax imposed by section 3, or one who elects under section 144 to take the standard deduction (see section 36);
- (2) A taxpayer who elects to deduct taxes paid or accrued to any foreign country or possession of the United States (see section 164);
- (3) A regulated investment company which has exercised the election under section 853.

§ 1.901-2 DEFINITION.—(a) The term “amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year” means taxes proper, paid or accrued during the taxable year on behalf of the taxpayer claiming credit. No credit is given for amounts representing interest or penalties.

(b) As used in sections 901-905, inclusive, the term “foreign country” means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income, war profits, or excess profits taxes.

(c) As used in sections 901-905, inclusive, the term "any possession of the United States" includes Guam, Puerto Rico and the Virgin Islands. But see section 931 and the regulations thereunder.

(d) The principles of sections 861 through 864 and the regulations thereunder shall apply in determining the sources of income for the purposes of sections 901-905, inclusive.

(e) For definitions generally, see section 7701 and the regulations thereunder.

## § 1.902 STATUTORY PROVISIONS; CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

### SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) **TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.**—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

(b) **FOREIGN SUBSIDIARY OF FOREIGN CORPORATION.**—If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of the corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

#### (c) APPLICABLE RULES.—

(1) The term "accumulated profits", when used in this section in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income; and the Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

(2) In the case of a foreign corporation, the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(d) **SPECIAL RULES FOR CERTAIN WHOLLY-OWNED FOREIGN CORPORATIONS.**—For purposes of this subtitle, if—

(1) a domestic corporation owns, directly or indirectly, 100 percent of all classes of outstanding stock of a foreign corporation engaged in manufacturing, production, or mining,

(2) such domestic corporation receives property in the form of a royalty or compensation from such foreign corporation pursuant to any form of contractual arrangement under which the domestic corporation agrees to furnish services or property in consideration for the property so received, and

(3) such contractual arrangement provides that the property so received by such domestic corporation shall be accepted by such domestic corporation in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends of any kind in any calendar year in

which such property is paid to such domestic corporation by such foreign corporation,  
 then the excess of the fair market value of such property so received by such domestic corporation over the cost to such domestic corporation of the property and services so furnished by such domestic corporation shall be treated as a distribution by such foreign corporation to such domestic corporation, and for purposes of section 301, the amount of such distribution shall be such excess, in lieu of any amount otherwise determined under section 301 without regard to this subsection; and the basis of such property so received by such domestic corporation shall be the fair market value of such property, in lieu of the basis otherwise determined under section 301(d) without regard to this subsection.

§ 1.902-1 TAXES OF FOREIGN CORPORATION.—(a) *Domestic corporation owning stock of a foreign corporation.*—In the case of a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes the income, war profits, and excess profits taxes deemed to have been paid by such domestic corporation. The amount of taxes so deemed to have been paid by the domestic corporation is determined by taking the same proportion of any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States by such foreign corporation, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. If dividends are received from more than one such foreign corporation, the taxes deemed to have been paid by the domestic corporation are computed separately for the dividends received from each such foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to such taxes as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by such a foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only. For other limitations on the amount of credit, see § 1.904-1.

(b) *Foreign corporation owning stock of another foreign corporation.*—If any foreign corporation (hereafter in this paragraph referred to as the former corporation) coming within the scope of paragraph (a) of this section owns 50 percent or more of the voting stock of another foreign corporation (hereafter in this paragraph referred to as the latter corporation) from which it receives dividends in any taxable year, the former corporation shall be deemed to have paid that proportion of any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States by the latter corporation, on or with respect to the accumulated profits of such latter corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. Such tax so deemed to have been paid shall then be taken into consideration in determining the amount of income, war profits, and excess profits taxes paid or deemed to have been paid by the former corporation to any possession or foreign country on or with respect to its own accumulated profits from which the dividends were paid by such corporation to the domestic corporation.

(c) *Source of income of foreign subsidiaries and country to which*

*tax is deemed to have been paid.*—For the purpose of section 904, dividends of a foreign corporation (at least 10 percent of whose voting stock is owned by a domestic corporation) shall be deemed to have been derived from sources within the foreign country or possession of the United States in which such foreign corporation is incorporated, to the extent that under section 862 (a) (2) such dividends are treated as income from sources without the United States. In addition, all income, war profits, and excess profits taxes paid or deemed to have been paid by such foreign corporation to any foreign country or possession of the United States shall be deemed to have been paid to the country or possession under whose laws such foreign corporation is incorporated.

(d) [Reserved.]

§ 1.902-2 SPECIAL RULES FOR PAYMENTS FROM CERTAIN WHOLLY-OWNED FOREIGN CORPORATIONS.—(a) *Qualifications.*—Section 902(d) provides a special rule for the purpose of allowing credit in accordance with section 902(a) for foreign taxes in the case of dividends paid by certain foreign corporations. Certain payments made by a wholly-owned foreign subsidiary to its domestic parent corporation shall be treated, to the extent prescribed in section 902(d) and paragraph (b) of this section, as distributions by the foreign corporation to the domestic corporation for purposes of subtitle A and thus for purposes of the foreign tax credit of the domestic parent. In order for the payments to qualify for the treatment provided by section 902(d) all the following conditions must be met:

(1) The domestic corporation must own (directly or indirectly) 100 percent of all classes of outstanding stock of a foreign corporation which is engaged in manufacturing, production, or mining.

(2) Such domestic corporation must receive property (including money) in the form of a royalty, or of compensation, from such foreign corporation pursuant to any form of contractual arrangement under which the domestic corporation agrees to furnish services or property in consideration for the property so received from the foreign corporation.

(3) Such contractual arrangement must provide that the property so received by such domestic corporation shall be accepted by such domestic corporation in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends of any kind in any calendar year in which such property is paid to the domestic corporation by such foreign corporation.

(b) *Amount and nature of distribution.*—In cases where section 902(d) applies, the excess of the fair market value of the property so received in lieu of dividends by the domestic corporation over the cost to it of the property and services so furnished by it shall be treated as a distribution of property by the foreign corporation to which section 301 applies. For purposes of section 301 (relating to distributions of property by a corporation to a shareholder) the amount of such distribution in lieu of dividends shall be such excess of the fair market value (on the date of distribution) of the property received by the domestic corporation over the cost of the property and services furnished by it, in lieu of any amount otherwise

determined under section 301 without regard to section 902(d). However, the amount determined under the preceding two sentences cannot exceed the amount which would constitute a dividend for the purposes of subtitle A, and thus for the purposes of section 902(a), if such excess had been declared and paid as a dividend by such foreign corporation. Any adjustment to the earnings and profits of the foreign corporation because of such distribution of property shall be made only in accordance with the provisions of section 312. The basis of the property so received by the domestic corporation shall be the fair market value of such property (on the date of distribution), in lieu of the basis otherwise determined under section 301(d) without regard to section 902(d).

(c) *Illustration of principles.*—The application of the principles of section 902(d) may be illustrated by the following example:

*Example.* A, a domestic corporation, has owned since January 1, 1950, 100 percent of all classes of outstanding stock of B, a foreign corporation engaged in the mining of certain ore (not constituting inventory assets as defined in section 312(b)(2)(A)). On February 1, 1950, A and B entered into a contractual arrangement under which A agreed to furnish technical services to B in consideration of a royalty payment by B of ten percent of the ore mined. The contractual arrangement further provides that the ore received by A shall be accepted in lieu of dividends and that B shall neither declare nor pay any dividends of any kind in any calendar year in which such ore is paid to A. In 1955, the cost to A of the technical services furnished under the contractual arrangement is \$30,000. The ore received by A during 1955, had an adjusted basis in the hands of B of \$40,000, and a fair market value of \$100,000. The earnings and profits of B accumulated as of the close of 1955, are \$200,000. Under these facts A has received from B in 1955 a distribution under section 902(d) of \$70,000 (\$100,000 minus \$30,000), which is includible in the gross income of A as a dividend in that amount. A is deemed to have paid, to the extent provided in section 902(a), foreign income taxes imposed on B on or with respect to the accumulated profits of B from which such dividend of \$70,000 was paid. The basis of A of the ore received is \$100,000, its fair market value. The accumulated earnings and profits of B shall be reduced by \$28,000 ( $\frac{\$70,000}{\$100,000} \times \$40,000$ ), i. e., that portion of the adjusted basis (in the hands of B immediately prior to the distribution) of the property distributed which is allocable to the distribution.

#### § 1.903 STATUTORY PROVISIONS; CREDIT FOR TAXES IN LIEU OF INCOME, ETC., TAXES.

##### SEC. 903. CREDIT FOR TAXES IN LIEU OF INCOME, ETC., TAXES.

For purposes of this subpart and of section 164(b), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

§ 1.903-1 DEFINITION OF TAXES IN LIEU OF INCOME, WAR PROFITS, OR EXCESS PROFITS TAXES.—(a) *In general.*—For the purposes of sections 901 through 905, inclusive, and section 164(b)(6), the term

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"income, war profits, and excess profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if—

(1) Such country or possession has in force a general income tax law,

(2) The taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and

(3) Such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.

(b) *Example.*—The application of section 903 may be illustrated by the following example:

*Example.* The A Corporation does business in X country, which imposes an income tax upon substantially a taxable income base. The ascertainment of taxable income, though not the determination of gross income, from sources in X country is found administratively difficult. The X country, by decree, provides that corporations circumstanced as was the A Corporation would, in lieu of the income tax at the rate of 20 percent otherwise payable, be subject to tax at the rate of 10 percent upon the amount of gross income from X country. In accordance with such decree the A Corporation paid X country the sum of \$25,000 in 1955 with respect to its tax liability to the X country for the year 1954. Such amount, subject to the applicable limitations, is available as a credit to the A Corporation as foreign income, war profits, or excess profits taxes against the United States tax liability for the year 1954.

## § 1.904 STATUTORY PROVISIONS; LIMITATION ON CREDIT.

### SEC. 904. LIMITATION ON CREDIT.

(a) **LIMITATION.**—The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) **TAXABLE INCOME FOR PURPOSE OF COMPUTING LIMITATION.**—For purposes of computing the limitation under subsection (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b).

§ 1.904-1 **LIMITATION ON CREDIT FOR FOREIGN TAXES.**—(a) *General.*—The amount allowable as a credit for income or profits taxes paid or accrued to a foreign country or a possession of the United States is subject to the limitation prescribed in section 904. This limitation provides that the credit for such taxes paid or accrued (including those deemed to have been paid) to each foreign country or possession of the United States may not exceed that proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) *Special computation of taxable income.*—For purposes of computing the limitation under paragraph (a), the taxable income in

the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under sections 151 or 642(b).

(c) *Illustration of principles.*—The operation of this limitation on the credit for foreign taxes paid or accrued may be illustrated by the following examples:

*Example (1).* The credit for foreign taxes allowable for 1954 in the case of X, an unmarried citizen of the United States who in 1954 received the income shown below and had three exemptions under section 151, is \$14,904, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States.....	\$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain.....	25,000
Total taxable income .....	\$75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions).....	44,712
British income and profits taxes.....	18,000
Limitation under section 904 $\left( \frac{25,000}{75,000} \text{ of } \$44,712 \right)$ .....	14,904
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitation under section 904) .....	14,904

*Example (2).* Assume the same facts as in example (1) except that the sources of X's income and taxes paid are as shown below. The credit for foreign taxes allowances to X is \$13,442.40, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States.....	\$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain.....	15,000
Taxable income (computed without deductions for personal exemptions) from sources within Canada.....	10,000
Total taxable income .....	\$75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions).....	44,712
British income and profits taxes.....	10,800
Limitation on British income and profits taxes under section 904 $\left( \frac{15,000}{75,000} \text{ of } \$44,712 \right)$ .....	8,942.40
Credit for British income and profits taxes (limited under section 904) .....	8,942.40
Canadian income and profits taxes.....	4,500
Limitation on Canadian income and profits taxes under section 904 $\left( \frac{10,000}{75,000} \text{ of } \$44,712 \right)$ .....	5,961.60
Credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount does not exceed the limitation under section 904) .....	4,500
Total amount of credit allowable (sum of credits—\$8,942.40 plus \$4,500) .....	13,442.40

*Example (3).* A domestic corporation realized taxable income in 1954 in the amount of \$100,000, consisting of \$50,000 from United States sources and dividends of \$50,000 from a French corporation, 20 percent of whose voting stock it owned. The French corporation

paid income and profits taxes to France on its income and in addition paid a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. The domestic corporation's credit for foreign taxes is \$23,250, computed as follows:

Taxable income from sources within the United States.....	\$50,000
Taxable income from sources within France.....	50,000
<hr/>	
Total taxable income .....	\$100,000
United States income tax.....	46,500
Dividend tax paid at source to France.....	19,000
Income and profits taxes deemed under section 902 to have been paid to France, computed as follows:	
Dividends received from French corporation during 1954..	\$50,000
Income of French corporation during 1954.....	200,000
Income and profits taxes paid to France on \$200,000.....	30,000
Accumulated profits (\$200,000 minus \$30,000).....	170,000
French taxes applicable to accumulated profits distributed:	
50,000	170,000
<u>170,000</u> of 200,000 of \$30,000 .....	7,500
<hr/>	
Total income and profits taxes paid and deemed to have been paid to France .....	\$26,500
Limitation under section 904	
( 50,000	
<u>100,000</u> of \$46,500) .....	23,250
Credit for French income and profits taxes (limited under section 904)	23,250

(d) *Joint return*.—In the case of a husband and wife making a joint return, the limitation prescribed by section 904 upon the credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be applied with respect to the aggregate taxable income from sources within each such country or possession, and the aggregate taxable income from all sources, of the spouses.

## § 1.905 STATUTORY PROVISIONS; APPLICABLE RULES.

### SEC. 905. APPLICABLE RULES.

(a) *YEAR IN WHICH CREDIT TAKEN*.—The credits provided in this subpart may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject, however, to the conditions prescribed in subsection (c). If the taxpayer elects to take such credits in the year in which the taxes of the foreign country or the possession of the United States accrued, the credits for all subsequent years shall be taken on the same basis, and no portion of any such taxes shall be allowed as a deduction in the same or any succeeding year.

(b) *PROOF OF CREDITS*.—The credits provided in this subpart shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary or his delegate—

(1) the total amount of income derived from sources without the United States, determined as provided in part I,

(2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this subpart, such amount to be determined under regulations prescribed by the Secretary or his delegate, and

(3) all other information necessary for the verification and computation of such credits.

(c) *ADJUSTMENTS ON PAYMENT OF ACCRUED TAXES*.—If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if



any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected. The amount of tax due on such redetermination, if any, shall be paid by the taxpayer on notice and demand by the Secretary or his delegate, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sec. 6511 and following). In the case of such a tax accrued but not paid, the Secretary or his delegate, as a condition precedent to the allowance of this credit, may require the taxpayer to give a bond, with sureties satisfactory to and to be approved by the Secretary or his delegate, in such sum as the Secretary or his delegate may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination; and the bond herein prescribed shall contain such further conditions as the Secretary or his delegate may require. In such redetermination by the Secretary or his delegate of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, and no deduction under section 164 (relating to deduction for taxes) shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary or his delegate, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

§ 1.905-1 WHEN CREDIT FOR TAXES MAY BE TAKEN.—(a) *In general.*—The credit for taxes provided in sections 901 to 905, inclusive, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 905(a) (or under the corresponding provisions of prior internal revenue laws) must be followed in returns for all subsequent years, and no portion of any such taxes accrued in a year in which a credit is claimed will be allowed as a deduction from gross income in any year. See also § 1.905-4.

(b) *Foreign income subject to exchange controls.*—If, however, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes im-

in the case of an individual or by Form 1118 in the case of a corporation.

(2) The form must be carefully filled in with all the information called for and with the calculations of credits indicated, and must be signed and contained or be verified by a written declaration that it is made under the penalties of perjury. Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the form must have attached to it (i) the receipt for each such tax payment if credit is sought for taxes already paid or (ii) the return on which each such accrued tax was based if credit is sought for taxes accrued. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. Any additional information necessary for the determination under sections 861 through 864 of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the district director, be furnished by the taxpayer.

(b) *Secondary evidence.*—Where it has been established to the satisfaction of the district director that it is impossible to furnish a receipt for such foreign tax payment, the foreign tax return, or direct evidence of the amount of tax withheld at the source, the district director, may, in his discretion, accept secondary evidence thereof as follows:

(1) *Receipt for payment.*—In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year.

(2) *Foreign tax return.*—If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, there shall be submitted—

- (i) A certified statement of the amount claimed to have accrued.
- (ii) Excerpts from the taxpayer's accounts showing amounts of foreign income and tax thereon accrued on its books,
- (iii) A computation of the foreign tax based on income from the foreign country carried on the books and at current rates of tax to be established by data such as excerpts from the foreign law, assessment notices, or other documentary evidence thereof,
- (iv) A bond, if deemed necessary by the district director, filed in the manner provided in cases where the foreign return is available, and

(v) In case a bond is not required, a specific agreement wherein the taxpayer shall recognize its liability to report the correct amount

of tax when ascertained, as required by the provisions of section 905(c).

If at any time the foreign tax receipts or foreign tax returns become available to the taxpayer, they shall be promptly submitted to the district director.

(3) *Tax withheld at source.*—In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

§ 1.905-3 REDETERMINATION OF THE TAX WHEN CREDIT PROVES INCORRECT.—(a) *In General.*—In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of § 301.6511(d)-3 of the regulations on procedure and administration.

(b) *Foreign tax imposed on foreign refund.*—Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, the amount of the taxes refunded for which credit has been allowed shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case no credit under section 901, and no deduction under section 164, shall be allowed for any taxable year with respect to such tax imposed on the refund.

(c) *Interest.*—Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, no interest shall be assessed or collected on the amount of tax due upon such redetermination resulting from such refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

§ 1.905-4 CREDIT FOR TAXES ACCRUED BUT NOT PAID.—In the case of a credit sought for a tax accrued but not paid, the district director may, as a condition precedent to the allowance of a credit, require a bond from the taxpayer, in addition to Form 1116 or 1118. If such

§ 1.905-2(b)(3)

a bond is required, Form 1117 shall be used by an individual; and Form 1119, by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the district director may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. See also 6 U. S. C. 15.

#### EARNED INCOME OF CITIZENS OF UNITED STATES

### § 1.911 STATUTORY PROVISIONS; EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

#### SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed \$20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to \$20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(b) DEFINITION OF EARNED INCOME.—For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

§ 1.911-1 EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.—(a) *Bona fide resident of a foreign country.*—(1) *Qualifications for exemption.*—Amounts constituting earned income as defined in section 911(b) shall be excluded from the gross income of an individual citizen of the United States who establishes to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, if such amounts are (i) from sources without the United States, (ii) attributable to such uninterrupted period, and (iii) not paid by the United States or any agency or instrumentality thereof. The exemption from tax thus provided is applicable to such amounts as are attributable to that portion of an uninterrupted period of bona fide foreign residence which falls within a taxable year during which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one entire taxable year. If attributable to an uninterrupted period in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.

(2) *What constitutes bona fide residence.*—Though the period of bona fide foreign residence must be continuous and uninterrupted, once bona fide residence in a foreign country or countries has been established, temporary visits to the United States or elsewhere on vacation or business trips will not necessarily deprive the citizen of his status as a bona fide resident of a foreign country. Whether the individual citizen of the United States is a bona fide resident of a foreign country shall be determined by the application, to the extent feasible, of the principles of section 871 and the regulations thereunder, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual.

(3) *Treatment of deductions.*—In any case in which any amount is excluded from gross income under the provisions of section 911(a) (1), there shall be disallowed as deductions any expenses, losses or other items otherwise deductible (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against the amounts so excluded from gross income. For example, traveling and entertainment expenses incurred by A, a citizen of the United States, for the production of earned income in foreign country X, where A had been a bona fide resident for a period of several years, would not be deductible to any extent, since such expenses are directly and entirely allocable to or chargeable against such exempt earned income. However, items which are not properly chargeable against or allocable to excludable earned income are deductible in their entirety (subject to any specific statutory limitations relating to such items). Examples of such items include personal and family medical expenses, real estate taxes on a personal residence, interest on mortgage on personal residence, and charitable contributions.

(4) *Earned income and employed assistants.*—The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or

all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(5) *Earned income from business in which capital is material.*—In the case of a taxpayer engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income, but the total amount which shall be treated as the earned income of the taxpayer from such a trade or business shall, in no case, exceed 30 percent of his share of the net profits of such trade or business. No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors; this question must be determined on all the facts of each individual case.

(6) *Source of income and place of receipt.*—An amount constituting earned income as defined in section 911(b) which is derived from sources without the United States shall not be included in gross income solely because it is received within the United States, since the place of receipt is immaterial in determining whether any items shall be excluded from gross income under the provisions of section 911(a). No amounts received for services performed within the United States shall be excluded from gross income by such section. For the allocation or segregation as between sources within, and sources without, the United States in the case of compensation for labor or personal services, see sections 861, 862, 863 and 864 and the regulations thereunder.

(7) *Returns.*—Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 911(a) (1) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 911(a) (1). A taxpayer desiring an extension of time (in addition to that granted by section 6081) for filing the return until after the completion of the qualifying period under section 911(a) (1) shall make application therefor with the district director, setting forth the facts relied upon to justify the extension of time requested and including a statement as to the earliest date he expects to be in a position to determine whether he will be entitled to the exclusion provided by section 911(a) (1). An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. For extensions of time for filing returns, see section 6081 and the regulations thereunder.

(8) *Declaration of estimated tax.*—In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 911(a) (1) and the regulations thereunder.

(9) *Definition of "foreign country."*—The term "foreign country" means territory under the sovereignty of a government other than that

of the United States. It does not include a possession or territory of the United States.

(b) PRESENCE IN A FOREIGN COUNTRY.—(1) *Qualifications for exemption.*—Subject to the limitations in subparagraph (2), amounts constituting earned income as defined in section 911(b) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i) from sources without the United States, (ii) attributable to such period, and (iii) not paid by the United States or any agency or instrumentality thereof. For purposes of determining the right to the exclusion under section 911(a) (2) for a taxable year to which the Internal Revenue Code of 1954 is applicable, the period of presence in a foreign country may include a period prior to the beginning of such taxable year, even though the tax for such prior period is computed under the Internal Revenue Code of 1939. For example, the qualifying period may, in the case of a taxpayer who makes his return on the calendar year basis, cover the period from July 1, 1953, to December 31, 1954, for purposes of the exclusion allowed under section 911(a) (2) for the taxable year 1954.

(2) *Amount of exemption.*—(i) The amount excluded from gross income under the provisions of section 911(a) (2) shall not exceed \$20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to \$20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* A, a citizen of the United States who files his returns for the calendar year using a cash receipts and disbursements method, was privately employed and physically present in France from January 1, 1953, through July 15, 1955. On December 31, 1953, he received compensation in the amount of \$20,000 for the services rendered by him during 1953. He left France on July 16, 1955, and returned to the United States. On August 1, 1955, he received \$30,000, part of which was for the services rendered by him during 1954 and the balance of which was for his services rendered during the period January 1, 1955, through July 15, 1955. On January 15, 1956, A received an additional \$10,000 for the services rendered by him during 1954.

(a) Since the \$20,000 compensation received by A on December 31, 1953, was attributable to an 18-month period during at least 510 full days of which he was present in a foreign country, and since that 18-month period included his entire taxable year 1953, the entire \$20,000 is exempt from taxation.

(b) Only \$12,712.33 ( $232/365 \times \$20,000$ ) of the \$30,000 received by A on August 1, 1955, is exempt from taxation since only 232 days of his taxable year 1955 is included within such an 18-month period. The number of days (232) is determined by treating the first day of the 18-month period as coinciding with the first day of the 510-day

period. The first day of the 510-day period ending July 15, 1955 (the last full day A was present in France), was February 21, 1954. Commencing with February 21, 1954, the 18-month period ends August 20, 1955. The number of days in that part of 1955 falling within the 18-month period is, therefore, 232 (January 1, 1955, through August 20, 1955). The amount excludable by A in 1955 (\$12,712.33) is computed on the basis of the following formula:

$$\frac{\text{Number of days in that part of the taxable year falling within the 18-month period}}{\text{Number of days in the taxable year}} \times \$20,000 \text{ (Maximum amount excludable for an entire taxable year under section 911(a)(2))} = \frac{232}{365} \times \$20,000.$$

(c) None of the \$10,000 attributable to the services rendered by A during 1954 but received by him in 1956 is exempt from taxation because no part of his taxable year 1956 is included within an 18-month period. For the definition of "taxable year" see section 7701(a)(23).

(3) *Returns*.—Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 911(a)(2) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 911(a)(2). A taxpayer desiring an extension of time (in addition to that granted by section 6081 and the regulations thereunder) for filing the return until after the completion of the qualifying period under section 911(a)(2) shall make application therefor with the district director, setting forth the facts relied upon to justify the extension of time requested and including a statement as to the earliest date he expects to be in a position to determine whether he will be entitled to the exclusion provided by section 911(a)(2). An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. For extensions of time for filing returns, see section 6081 and the regulations thereunder.

(4) *Declaration of estimated tax*.—In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 911(a)(2) and the regulations thereunder.

(5) *Earned income, source of income, and place of receipt*.—The provisions of paragraph (a) of this section respecting the definition of earned income, the source of income, and the immateriality of the place of receipt of amounts constituting earned income are equally effective in the application of this paragraph.

(6) *Treatment of deductions*.—In any case in which any amount is excluded from gross income under section 911(a)(2), there shall be disallowed as deductions any expenses, losses, or other items otherwise deductible (other than those allowed by section 151 relating to personal exemptions), properly allocable to or chargeable against the amount so excluded from gross income. If the earned income excludable under section 911(a)(2) (determined without regard to the \$20,000



limitation) exceeds the earned income excludable under section 911(a)(2), the amount disallowed as a deduction shall be limited to an amount which bears the same ratio to the total of such items properly allocable to or chargeable against such earned income so excludable (determined without regard to the \$20,000 limitation) as the amount excluded from gross income under section 911(a)(2) bears to such earned income (determined without regard to the \$20,000 limitation). However, deductions which are not properly allocable to or chargeable against earned income excluded under section 911(a)(2) are deductible in their entirety (subject to specific statutory limitations relating to such items). For examples of deductions which must be allowed or disallowed under this paragraph see § 1.911-1(a)(3).

(7) *Definition of "foreign country".*—The term "foreign country" means territory under the sovereignty of a government other than that of the United States and includes the air space over such territory. It does not include a possession or territory of the United States.

(8) *Determination of 18-month period.*—The exclusion provided by section 911(a)(2) applies to income attributable to any period of 18 consecutive months during which the citizen satisfies the 510 full-day requirement, even though such period constitutes a part of a longer period of presence in a foreign country or countries. For this purpose, the term "18 consecutive months" means any period of such duration, that is, any period commencing with the beginning of any day of a calendar month and terminating (i) with the close of the day which precedes that day in the eighteenth succeeding calendar month numerically corresponding to the day of the period's beginning, or, if there is no such corresponding day, (ii) with the close of the last day of such eighteenth succeeding month. Such period need not necessarily commence with the day of arrival in a foreign country, nor terminate with the day of departure therefrom. In no event will the 510 full-day requirement be prorated over a period of less than 18 consecutive months.

(9) *Examples of 18-month periods.*—Thus, a citizen who arrives in a foreign country on January 1, 1953, makes several return trips to the United States, and then finally departs from the foreign country on February 14, 1955, may not be present in such country for 510 full days during the 18-month period commencing with January 1, 1953, and ending with the close of June 30, 1954, because of his visits to the United States during such period, but may satisfy the 510 full-day requirement during the 18-month period commencing with February 15, 1953, and ending with the close of August 14, 1954. In such event, the exclusion will apply to income attributable to the latter period, but not to income attributable to the period commencing with January 1, 1953, and ending with the close of February 14, 1953. For such purpose, it is assumed that no part of the period ending with the close of February 14, 1953, is included in any 18-month period during which the 510 full-day requirement is satisfied. Furthermore, the mere fact that the 510 full-day requirement has been satisfied with respect to the period ending with the close of August 14, 1954, does not mean that income earned thereafter will be excluded under section 911(a)(2) unless such income is attributable to another 18-month period during which there is compliance with the 510 full-

day requirement. Thus, the 510 full-day requirement cannot be prorated over the 6-month period commencing with August 15, 1954, and ending with the close of February 14, 1955, in order to determine whether the exclusion allowed by section 911(a) (2) applies to income attributable to such 6-month period. Therefore, assuming that the citizen is present in the foreign country 170 full days ( $\frac{1}{3}$  of 510 full days) during such 6-month period ( $\frac{1}{3}$  of 18 consecutive months), the exclusion will not be applicable to income attributable to any part of such 6-month period if no part thereof is included in any 18-month period during which the 510 full-day requirement is satisfied.

(10) *Definition of "full-day"*.—The term "full day" means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight. In computing the minimum of 510 full days of presence in a foreign country or countries, all separate periods of such presence during the period of 18 consecutive months are to be aggregated. For the purpose of section 911(a) (2), if an individual travels over a route (a portion of which is not within any country) from one place in a foreign country to another place in the same country, or to a place in another foreign country, and if such travel not within any country extends over a period of less than 24 hours and does not involve travel within the United States or any possession thereof, such individual shall not be deemed outside a foreign country during the period of such travel. The 510 full days need not be consecutive, but may be interrupted by periods during which the citizen is not present in a foreign country. Time spent in a foreign country in the employment of the United States Government will count toward satisfaction of the 510 full-day requirement, even though amounts paid by such Government are not exempt from tax under section 911(a) (2).

(11) *Illustrations of application of the 510-day rule*.—The application of the 510-day rule may be illustrated by the following examples:

*Example (1)*. On February 1, 1954, B, a citizen of the United States privately employed, arrived in Puerto Rico on a business assignment. Upon completion of the assignment he departed for a new assignment in Venezuela, arriving there on April 24, 1954. He remained in Venezuela until 2 p. m. on October 25, 1955, at which time he departed for another assignment in Puerto Rico. On January 10, 1956, he left Puerto Rico for a new assignment in the United States. During the 18-month period commencing with April 25, 1954, and ending with the close of October 24, 1955, the taxpayer was in a foreign country at least 510 full days; in addition, during the 18-month period commencing with June 2, 1954, and ending with the close of December 1, 1955, he was in a foreign country an aggregate of 510 full days.

*Example (2)*. At 2 p. m. on January 18, 1953, C, a citizen of the United States privately employed, arrived in England on a business trip from the United States. On May 20, 1953, at 10 p. m. he departed from England by steamer and arrived in the United States on May 25, 1953. After spending a period therein on official business, he left the United States by steamer on June 9, 1953, and arrived in France at 3 p. m., June 14, 1953. At 8 a. m. on February 3, 1954, he

departed from France by airplane for a brief visit to Puerto Rico, arriving there on February 4, 1954, and thence went to England, arriving there at 1 a. m. on February 12, 1954, where he remained until midnight, July 18, 1954, at which time the 510 full-day requirement was satisfied in respect of the period of 18 consecutive months which began with January 19, 1953. C continued his presence in England, not leaving that country until 5 a. m. on November 18, 1954, at which time he departed for the United States. During the 18-month period commencing with January 19, 1953, and ending with the close of July 18, 1954, the taxpayer was in a foreign country or countries an aggregate of 510 full days; in addition, during the 18-month period commencing with June 16, 1953, and ending with the close of December 15, 1954, he was in a foreign country or countries an aggregate of 510 full days. The computation with respect to each period may be illustrated as follows:

	<i>Full days in foreign country</i>
<b>FIRST 18-MONTH PERIOD (JAN. 19, 1953 THROUGH JULY 18, 1954) :</b>	
Jan. 19, 1953 through May 19, 1953.....	121
May 20, 1953 through June 14, 1953.....	0
June 15, 1953 through Feb. 2, 1954.....	233
Feb. 3, 1954 through Feb. 12, 1954.....	0
Feb. 13, 1954 through July 18, 1954.....	156
Total full days .....	510
<b>SECOND 18-MONTH PERIOD (JUNE 16, 1953 THROUGH DEC. 15, 1954) :</b>	
June 16, 1953 through Feb. 2, 1954.....	232
Feb. 3, 1954 through Feb. 12, 1954.....	0
Feb. 13, 1954 through Nov. 17, 1954.....	278
Nov. 18, 1954 through Dec. 15, 1954.....	0
Total full days .....	510

*Example (3).* On March 6, 1953, at 3 p. m., D, a citizen privately employed, arrived in Cuba, where he remained until 9 p. m., June 25, 1953, at which time he departed from Cuba for a short business trip to Puerto Rico. Upon completion of his negotiations, he departed for Mexico, arriving there at 2 p. m. on July 24, 1953, where he remained until 10 a. m., August 22, 1954, at which time he departed from such country for a vacation in the United States. He arrived again in Mexico at 9 a. m. on September 5, 1954, where he remained until 8 a. m., January 1, 1955, at which time he departed from such country for a new assignment in the United States. During the 18-month period commencing with March 7, 1953, and ending with the close of September 6, 1954, the taxpayer was in a foreign country or countries an aggregate of 504 full days; during the 18-month period commencing with July 1, 1953, and ending with the close of December 31, 1954, he was in a foreign country an aggregate of 510 full days. The computation with respect to each period may be illustrated as follows:

	<i>Full days in foreign country</i>
<b>FIRST 18-MONTH PERIOD (MAR. 7, 1953 THROUGH SEPT. 6, 1954):</b>	
Mar. 7, 1953 through June 24, 1953.....	110
June 25, 1953 through July 24, 1953.....	0
July 25, 1953 through Aug. 21, 1954.....	393
Aug. 22, 1954 through Sept. 5, 1954.....	0
Sept. 6, 1954 .....	1
Total full days .....	504
<b>SECOND 18-MONTH PERIOD (JULY 1, 1953 THROUGH DEC. 31, 1954):</b>	
July 1, 1953 through July 24, 1953.....	0
July 25, 1953 through Aug. 21, 1954.....	393
Aug. 22, 1954 through Sept. 5, 1954.....	0
Sept. 6, 1954 through Dec. 31, 1954.....	117
Total full days .....	510

## § 1.912 STATUTORY PROVISIONS; EXEMPTION FOR CERTAIN ALLOWANCES.

### SEC. 912. EXEMPTION FOR CERTAIN ALLOWANCES.

The following items shall not be included in gross income, and shall be exempt from taxation under this subtitle:

(1) **COST-OF-LIVING ALLOWANCES.**—In the case of civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President.

(2) **FOREIGN SERVICE ALLOWANCES.**—In the case of an officer or employee of the Foreign Service of the United States, amounts received by such officer or employee as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131-1158).

### § 1.912-1 EXCLUSION OF CERTAIN COST-OF-LIVING ALLOWANCES.—

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a "living and quarters allowance," would be excluded from gross income whether or not any other portion of such allowance is excluded from gross income.

(b) For the purposes of section 912(1) the term "continental United States" includes only the States of the Union and the District of Columbia.

§ 1.912-2 **EXCLUSION OF CERTAIN ALLOWANCES OF FOREIGN SERVICE PERSONNEL.**—Amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131-1158) are, by the provisions of section 912(2), excluded from gross income.

# § 1.921 STATUTORY PROVISIONS; DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS.

## WESTERN HEMISPHERE TRADE CORPORATIONS

### SEC. 921. DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS.

For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:

- (1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and
  - (2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.
- For any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the Internal Revenue Code of 1939 shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

§ 1.921-1 DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATION.—(a) *In general.*—The term "Western Hemisphere trade corporation", for purposes of subtitle A of the Internal Revenue Code of 1954, means a domestic corporation which meets all of the following tests:

- (1) Its entire business for the taxable year is carried on within the Western Hemisphere. In determining whether this test is met, incidental purchases outside the Western Hemisphere will not disqualify the corporation. The term "incidental purchases" as used in section 921 and this section does not have the same meaning as the phrase "purchases incident to the conduct of the business". The term "incidental purchases" means only purchases (of any kind and for any purpose) which are (i) minor in relation to the entire business or (ii) nonrecurring or unusual in character. Whether purchases made outside the Western Hemisphere are incidental purchases for purposes of section 921 and this section shall be determined on the basis of all the facts of each particular case, except that in any case in which the aggregate of the purchases (of any kind and for any purpose) made outside the Western Hemisphere for the taxable year does not exceed an amount equal to 5 percent of the corporation's gross receipts from all sources for such taxable year such purchases shall be deemed to be incidental purchases. Merely incidental economic contact with countries outside the Western Hemisphere will not disqualify a corporation as a Western Hemisphere trade corporation. For purposes of this section, the term "Western Hemisphere" means the countries in North, Central, and South America, and in the West Indies;

- (2) Ninety-five percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such

part of such period during which the corporation was in existence) is derived from sources without the United States; and

(3) Ninety percent or more of its gross income for such period or such part thereof is derived from the active conduct of a trade or business. Dividends received by a corporation do not represent income derived from the active conduct of a trade or business.

(b) *Illustrations.*—The application of the principles of paragraph (a) of this section may be illustrated by the following examples:

*Example (1).* X, a domestic corporation, operates a mine in South America and ships its products to England. The fact that X retains title to such goods until acceptance of the bill of lading and draft, solely in order to insure collection, will not cause X to be considered as carrying on business outside the Western Hemisphere, since such passing of title is merely an incidental economic contact outside the Western Hemisphere.

*Example (2).* Y, a domestic corporation, is engaged in Argentina in the business of manufacturing and selling construction equipment. During 1956, Y purchased in Germany certain motor parts required as an integral part of the equipment which it makes. The amount of such purchases equalled 4 percent of Y's gross receipts for 1956. Such purchases are incidental purchases and do not disqualify Y as a Western Hemisphere trade corporation.

*Example (3).* Z, a domestic corporation, operates a mine in South America. During 1956, Z, in accordance with its usual practices, purchased in France machinery and equipment necessary in the conduct of its business. The amount of such purchases was not minor in relation to Z's entire business. Such purchases disqualify Z as a Western Hemisphere trade corporation.

(c) *Statement required.*—A corporation which claims to qualify as a Western Hemisphere trade corporation shall attach to its income tax return a statement showing: (1) That its entire business is done within the Western Hemisphere and, if any purchases are made outside the Western Hemisphere, the amount of such purchases, the amount of its gross receipts from all sources, and any other pertinent information, and (2) for the 3-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence), (i) its total gross income from all sources, (ii) the amount thereof derived from the active conduct of a trade or business, (iii) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (iv) the amount of its gross income, if any, from sources within the United States. The gross income from sources within the United States and without the United States shall be determined as provided in sections 861, 862, 863, 864, and the regulations thereunder.

## § 1.922 STATUTORY PROVISIONS; SPECIAL DEDUCTION.

### SEC. 922. SPECIAL DEDUCTION.

In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows—

(1) First determine the taxable income of such corporation computed without regard to this section.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

§ 1.922-1(a) SPECIAL DEDUCTION OF WESTERN HEMISPHERE TRADE CORPORATION.—A special deduction in computing taxable income in the case of a Western Hemisphere trade corporation (as defined in section 921), is allowed in section 922. The fraction specified in section 922(2) is the same whether the amount of the corporation's taxable income is sufficient to subject it to the combined normal tax and surtax, or only to the normal tax. For the rules applicable in determining the special deduction where the alternative tax under section 1201 is imposed, see the regulations under section 1201.

(b) *Examples.*—The computation of the special deduction may be illustrated by the following examples:

*Example (1).* A corporation which qualifies as a Western Hemisphere trade corporation realized gross income of \$100,000 for the calendar year 1954 and had allowable deductions (other than the special deduction allowed by section 922) for that year in the amount of \$40,000. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The corporation's special deduction under section 922 is \$16,153.84, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of \$40,000 from gross income of \$100,000, with a result of \$60,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922 (2), accordingly, is  $14/52$ .

(iii) The amount of taxable income (subdivision (i)), \$60,000 multiplied by the fraction determined under subdivision (ii),  $14/52$ , is \$16,153.84 ( $14/52$  times \$60,000).

*Example (2).* Assume that the facts are the same as in example (1) except that the allowable deductions (other than the special deductions allowed by section 922) are \$80,000. The corporation's special deduction under section 922 is \$5,384.61, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of \$80,000 from gross income of \$100,000, with a result of \$20,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922(2), accordingly, is  $14/52$ , regardless of the fact that the taxable income of the corporation in the amount of \$20,000 makes it subject only to the corporation normal tax.

(iii) The amount of taxable income (subdivision (i)), \$20,000 multiplied by the fraction determined under subdivision (ii),  $14/52$ , is \$5,384.61 ( $14/52$  times \$20,000).

# § 1.931 STATUTORY PROVISIONS; INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES.

## SEC. 931. INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES.

(a) GENERAL RULE.—In the case of citizens of the United States or domestic corporations, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) THREE-YEAR PERIOD.—If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States and;

(2) TRADE OR BUSINESS.—If—

(A) in the case of such corporation, 50 percent or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(B) in the case of such citizen, 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) AMOUNTS RECEIVED IN UNITED STATES.—Notwithstanding subsection (a), there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) DEFINITION.—For purposes of this section, the term "possession of the United States" does not include the Virgin Islands of the United States, and such term when used with respect to citizens of the United States does not include Puerto Rico.

(d) DEDUCTIONS.—

(1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by section 873 in the case of a nonresident alien individual engaged in trade or business within the United States.

(2) Domestic corporations entitled to the benefits of this section shall have the same deductions as are allowed by section 882(c) in the case of a foreign corporation engaged in trade or business within the United States.

(e) DEDUCTION FOR PERSONAL EXEMPTION.—A citizen of the United States entitled to the benefits of this section shall be allowed a deduction for only one exemption under section 151.

(f) ALLOWANCE OF DEDUCTIONS AND CREDITS.—Persons entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of their total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits.

(g) FOREIGN TAX CREDIT.—Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(h) INTERNEES.—In the case of a citizen of the United States interned by the enemy while serving as an employee within a possession of the United States—

(1) if such citizen was confined in any place not within a possession of the United States, such place of confinement shall, for purposes of



this section, be considered as within a possession of the United States; and

(2) subsection (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) **EMPLOYEES OF THE UNITED STATES.**—For purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

§ 1.931-1 **CITIZENS OF THE UNITED STATES AND DOMESTIC CORPORATIONS DERIVING INCOME FROM SOURCES WITHIN A CERTAIN POSSESSION OF THE UNITED STATES.**—(a) *Definitions.*—(1) As used in section 931 and this section, the term “possession of the United States” includes the Panama Canal Zone, Guam, American Samoa, Wake and the Midway Islands, and Puerto Rico when used with respect to domestic corporations. The term does not include the Virgin Islands, nor does it include Puerto Rico when used with respect to citizens of the United States.

(2) As used in section 931 and this section, the term “United States” includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) *General rule.*—(1) *Qualifications.*—In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(i) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(ii) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. The salary or other compensation paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 931 and this section, be deemed to be derived from sources within the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, does not represent income derived from the active conduct of a trade or business within the possession of the United States even though such citizen was actively engaged in the management of such corporation. For a determination of income from sources within the United States, see sections 861, 862, 863, 864, 931 and the regulations thereunder.

(2) *Relationship of sections 931 and 911.*—A citizen of the United States who cannot meet the 80-percent and the 50-percent requirements of section 931 but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of earned income from sources outside the United States), provided he meets the requirements thereof. In such a case none of the provisions of section 931 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 911 (b).

(3) *Meaning of "gross income" on joint return.*—In the case of a husband and wife making a joint return, the term "gross income," as used in this section, means the combined gross income of the spouses.

(4) *Returns.*—A citizen entitled to the benefits of section 931 is required to file with his individual return Form 1040 the schedule on Form 1040E. If a citizen entitled to the benefits of section 931 has no income from sources within the United States and does not receive within the United States any income derived from sources without the United States he is not required to file a return or the schedule on Form 1040E.

(5) *Illustration of the operation of section 931.*—This section may be illustrated by the following example:

*Example.* On July 1, 1954, A, who is a citizen of the United States, went to a possession of the United States and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was \$20,000. In addition, he made a profit of \$12,000 from the sale during the latter part of 1954 of some real estate located in such possession and not connected with his trade or business. In the first six months of 1954 he also derived \$8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1954. On these facts, A may exclude the \$32,000 derived from sources within the possession of the United States, since he qualified under section 931 with respect to that amount. The period of July 1, 1954, through December 31, 1954, constitutes the applicable part of the 3-year period immediately preceding the close of the taxable year (the calendar year 1954), and for that period, 80 percent of A's gross income was derived from sources within a possession of the United States (\$32,000, or 80 percent of \$40,000) and 50 percent or more of A's gross income was derived from the active conduct of a trade or business within a possession of the United States (\$20,000, or 50 percent of \$40,000). A is required to report on his return for 1954 only the gross income derived by him from sources within the United States (\$16,000 from the rental property located in the United States).

(c) *Amounts received in United States.*—Notwithstanding the provisions of section 931 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated

thereto. For instance, if in the example set forth in § 1.931-1(b)(5), the taxpayer during the latter part of 1954 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the real estate located in the possession, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 931 with respect to other items of gross income excluded by that section.

(d) *Deductions.*—(1) *Individuals.*—In the case of a citizen entitled to the benefits of section 931, the deductions allowed in computing taxable income, except the standard deduction and a deduction for one personal exemption (see sections 142(b)(2) and 931(e), respectively), are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of section 873 and the regulations thereunder, relating to the allowance to nonresident alien individuals, who at any time within the taxable year were engaged in trade or business within the United States, of the deductions provided in section 165(c)(2) and (3) for losses not connected with the trade or business, are applicable in the case of citizens entitled to the benefits of section 931. The provisions of section 873(c) and the regulations thereunder pertaining to the allowance to such nonresident alien individuals of deductions for contributions provided in section 170 are also applied in the case of such citizens.

(2) *Corporations.*—Corporations entitled to the benefits of section 931 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction provided by section 170 to corporations is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in sections 861, 862, 863, 864, and the regulations thereunder.

(e) *Deduction for personal exemption.*—A citizen of the United States entitled to the benefits of section 931 is allowed a deduction for only one exemption under section 151.

(f) *Allowance of deductions and credits.*—Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 931 shall file or cause to be filed with the district director a true and accurate return of total income from all sources within the United States, in a manner prescribed in subtitle F of the Internal Revenue Code of 1954, the tax shall be collected on the basis of the gross income (not the taxable income) from sources within the United States. If such citizen or corporation fails to file a necessary income tax return, the Commissioner will cause a return to be made, including therein all income from sources within the United States and allowing no deductions or credits (except credit for tax withheld at source).

(g) *Foreign tax credit.*—Persons entitled to the benefits of section 931 are not allowed the credits provided for in section 901 (relating to credits for taxes of foreign countries and possessions).

(h) *Internees*.—If a citizen of the United States—

(1) Was interned by the enemy while serving as an employee within a possession of the United States; and

(2) Was confined in any place not within a possession of the United States, then

(i) Such place of confinement shall be considered as within a possession of the United States for the purposes of section 931; and

(ii) Section 931(b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) *Employees of the United States*.—For the purposes of section 931, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

## § 1.932 STATUTORY PROVISIONS; TAXATION OF CITIZENS OF POSSESSIONS OF THE UNITED STATES.

### SEC. 932. CITIZENS OF POSSESSIONS OF THE UNITED STATES.

(a) *GENERAL RULE*.—Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources. This section shall have no application in the case of a citizen of Puerto Rico.

(b) *VIRGIN ISLANDS*.—Nothing in this section shall be construed to alter or amend the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921 (48 U. S. C. 1397), relating to the imposition of income taxes in the Virgin Islands of the United States.

(c) *GUAM*.—For applicability of United States income tax laws in Guam, see section 31 of the Act of August 1, 1950 (48 U. S. C. 1421i); for disposition of the proceeds of such taxes, see section 30 of such Act (48 U. S. C. 1421h).

### § 1.932-1 STATUS OF CITIZENS OF THE UNITED STATES POSSESSIONS—

(a) *General rule*.—(1) *Definition and treatment*.—A citizen of a possession of the United States (except Puerto Rico), who is not otherwise a citizen or resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. See sections 871 through 877, and the regulations thereunder, for rules relating to imposition of tax on nonresident alien individuals. For Federal income tax purposes, a citizen of a possession of the United States who is not otherwise a citizen of the United States is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. See section 1441.

(2) *Classification of citizens of United States possessions.*—For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (i) Citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States, and (ii) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States. The provisions of sections 871 to 877, inclusive, and the regulations thereunder, applicable to non-resident alien individuals not engaged in trade or business within the United States, are applicable to the citizens of possessions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(b) *No application to citizen of Puerto Rico.*—The provisions of section 932(a) and this section shall have no application in the case of a citizen of Puerto Rico.

### § 1.933 STATUTORY PROVISIONS; INCOME FROM SOURCES WITHIN PUERTO RICO.

#### SEC. 933. INCOME FROM SOURCES WITHIN PUERTO RICO.

The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) *RESIDENT OF PUERTO RICO FOR ENTIRE TAXABLE YEAR.*—In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction under section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) *TAXABLE YEAR OF CHANGE OF RESIDENCE FROM PUERTO RICO.*—In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received for services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date; but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction for personal exemptions under section 151) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

§ 1.933-1 *EXCLUSION OF CERTAIN INCOME FROM SOURCES WITHIN PUERTO RICO.*—(a) *General rule.*—An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, shall exclude from his gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. Whether the individual is a bona fide resident of Puerto Rico shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 1.871-2, 1.871-3, 1.871-4, and 1.871-5, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of

an alien individual. Once bona fide residence in Puerto Rico has been established, temporary absence therefrom in the United States or elsewhere on vacation or business trips will not necessarily deprive an individual of his status as a bona fide resident of Puerto Rico. An individual taking up residence in Puerto Rico during the course of the taxable year is not entitled for such year to the exclusion provided in section 933.

(b) *Taxable year of change of residence from Puerto Rico.*—A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) *Deductions.*—In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions) properly allocable to, or chargeable against, the amounts so excluded from gross income.

#### CHINA TRADE ACT CORPORATIONS

### § 1.941 STATUTORY PROVISIONS; SPECIAL DEDUCTION FOR CHINA TRADE ACT CORPORATIONS.

#### SEC. 941. SPECIAL DEDUCTION FOR CHINA TRADE ACT CORPORATIONS.

(a) *ALLOWANCE OF DEDUCTION.*—For purposes only of the taxes imposed by section 11, there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4, sec. 141 and following), in addition to the deductions from taxable income otherwise allowed such corporation, a special deduction, in computing the taxable income, of an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a similar manner to that provided in part I) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by—

(1) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and

(2) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date. In no case shall the diminution, by reason of such special deduction, of the taxes imposed by section 11 (computed without regard to this section) exceed the amount of the special dividend certified under subsection (b) of this section.

(b) *SPECIAL DIVIDEND.*—The special deduction provided in subsection (a) shall not be allowed unless the Secretary of Commerce has certified to the Secretary of the Treasury or his delegate—

(1) the amount which, during the year ending on the date fixed by law for filing the return, the corporation has distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation;

(2) that such special dividend was in addition to all other amounts, payable or to be payable to such persons or for their benefit, by reason of their interest in the corporation; and

(3) that such distribution has been made to or for the benefit of such persons in proportion to the par value of the shares of stock of the corporation owned by each except that if the corporation has more than one class of stock, the certificates shall contain a statement that the articles of incorporation provide a method for the apportionment of such special dividend among such persons, and that the amount certified has been distributed in accordance with the method so provided.

(c) OWNERSHIP OF STOCK.—For purposes of this section, shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

§ 1.941-1 SPECIAL DEDUCTION FOR CHINA TRADE ACT CORPORATIONS.—In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in sections 861, 862, 863, 864, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

§ 1.941-2 MEANING OF TERMS USED IN CONNECTION WITH CHINA TRADE ACT CORPORATIONS.—(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U. S. C., ch. 4, sec. 141 *et seq.*).

(b) The term "special dividend" means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) "Taxable income derived from sources within Formosa and Hong Kong" is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in sections 861, 862, 863, 864, and the regulations thereunder.

§ 1.941-3 ILLUSTRATION OF PRINCIPLES.—The application of section 941 may be illustrated by the following example:

*Example.* (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of \$200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to \$100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941(b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

Taxable income .....	\$200,000
Normal tax (section 11(b)) .....	60,000
Surtax (section 11(c)) .....	38,500
Total income tax .....	98,500

(3) Second computation; allowing the special deduction from taxable income.

Taxable income .....	\$200,000
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Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

Special deduction from taxable income .....	\$200,000
Amount of income subject to tax under section 11 .....	None

(4) Since the special dividend (\$100,000) exceeds the diminution of the tax (\$98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowance and the corporation has no income tax liability for 1954.



## § 1.942 STATUTORY PROVISIONS; DISALLOWANCE OF FOREIGN TAX CREDIT.

### SEC. 942. DISALLOWANCE OF FOREIGN TAX CREDIT.

A corporation organized under the China Trade Act, 1922, shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

## § 1.943 STATUTORY PROVISIONS; EXCLUSION OF DIVIDENDS TO RESIDENTS OF FORMOSA OR HONG KONG.

### SEC. 943. EXCLUSION OF DIVIDENDS TO RESIDENTS OF FORMOSA OR HONG KONG.

Amounts distributed as dividends to or for the benefit of any person by a corporation organized under the China Trade Act, 1922, shall not be included in gross income and shall be exempt from taxation under this subtitle if, at the time of such distribution, such person is a resident of Formosa or Hong Kong, and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.

§ 1.943-1 WITHHOLDING BY A CHINA TRADE ACT CORPORATION.—Dividends distributed by a China Trade Act corporation which are treated as income from sources within the United States under the provisions of sections 861, 862, 863, 864, and the regulations thereunder are subject to withholding at the rate of 30 percent when paid to persons (other than residents of Formosa and Hong Kong) who are (a) nonresident aliens, (b) nonresident partnerships composed in whole or in part of nonresident aliens, or (c) nonresident foreign corporations. The 30 percent rate of withholding specified in this section with respect to dividends shall be reduced to such rate as may be provided by treaty with any country. See section 1441 and the regulations thereunder.

## GAIN OR LOSS ON DISPOSITION OF PROPERTY

### DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

## § 1.1001 STATUTORY PROVISIONS; DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

### SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this

section shall be recognized for purposes of this subtitle shall be determined under section 1002.

(d) **INSTALLMENT SALES.**—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

§ 1.1001-1 **COMPUTATION OF GAIN OR LOSS.**—(a) *General rule.*—Except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and regulations thereunder (i. e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder.

(b) *Real estate taxes as amounts received.*—(1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of

sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also § 1.1012-1(b).

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that the contract price on the sale of a parcel of real estate is \$50,000 and that real property taxes thereon in the amount of \$1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that \$750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is \$50,000. Similarly, \$50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of \$50,000, the amount realized by the seller would be \$49,250, since the sales price would be deemed to include \$750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, \$49,250 would be the purchaser's cost.

*Example (2).* Assume that the purchaser in example (1) above, paid all of the real property taxes. Assume further that \$250 of the taxes are treated under section 164(d) as imposed upon the seller. The amount realized by the seller is \$50,250. Similarly, \$50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

*Example (3).* Assume that the seller described in the first part of example (1), above, paid the real property taxes of \$1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the \$1,000 of taxes. In such a case, the amount realized is \$50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the \$750 of taxes treated under section 164(d) as imposed upon him, in which case his adjusted basis would be \$50,750 (cost of \$50,000 plus capitalized taxes of \$750).

(c) *Other rules.*—(1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Internal Revenue Code of 1954 to be applied against the basis of the property exceeds such basis. Except as otherwise provided in section 301(c) (3) (B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as "income from whatever source derived". On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other dispositions occurs there re-

mains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for \$10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to \$1,000 by reason of receipts and distributions described in sections 1016(a)(1) and 1016(a)(4). He received in 1954 a further distribution of \$5,000, being a distribution covered by section 1016(a)(4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016(a)(4) exceeds that basis by \$4,000. The \$4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for \$5,000, he realizes in 1955 a gain of \$5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.*—In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.*—(1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For determination of basis of the property in the hands of the transferee see § 1.1015-4.

(2) *Examples.*—The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* A transfers property to his son for \$60,000. Such property in the hands of A has an adjusted basis of \$30,000 (and a fair market value of \$90,000). A's gain is \$30,000, the excess of \$60,000, the amount realized, over the adjusted basis, \$30,000. He has made a gift of \$30,000, the excess of \$90,000, the fair market value, over the amount realized, \$60,000.

*Example (2).* A transfers property to his son for \$30,000. Such property in the hands of A has an adjusted basis of \$60,000 (and a fair market value of \$90,000). A has no gain or loss, and has made a gift of \$60,000, the excess of \$90,000, the fair market value, over the amount realized, \$30,000.

*Example (3).* A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$30,000 (and a fair market value of \$60,000). A has no gain and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized, \$30,000.

*Example (4).* A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$90,000 (and a fair

market value of \$60,000). A has sustained no loss, and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized \$30,000.

§ 1.1002 STATUTORY PROVISIONS; RECOGNITION OF GAIN OR LOSS.  
SEC. 1002. RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

§ 1.1002-1 SALES OR EXCHANGES.—(a) *General rule*.—The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Internal Revenue Code of 1954 provide otherwise.

(b) *Strict construction of exceptions from general rule*.—The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code of 1954 only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule*.—Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code of 1954 provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange*.—Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

## BASIS RULES OF GENERAL APPLICATION

## § 1.1011 STATUTORY PROVISIONS; ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

## SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

§ 1.1011-1 ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Internal Revenue Code of 1954, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

## § 1.1012 STATUTORY PROVISIONS; BASIS OF PROPERTY—COST.

## SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

§ 1.1012-1 BASIS OF PROPERTY.—(a) *General rule.*—In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. This general rule is subject to exceptions stated in subchapter O (relating to gain or loss on the disposition of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses) of chapter 1 of the Internal Revenue Code of 1954.

(b) *Real estate taxes as part of cost.*—In computing the cost of real property, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. This rule applies whether or not the contract of sale calls for the purchaser to reimburse the seller for such real estate taxes paid or to be paid by the seller. On the other hand, where the purchaser pays (or assumes liability for) real estate taxes which are treated under section 164(d) as imposed upon the seller, such taxes shall be considered part of the cost of the property. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, real estate taxes allocable to the seller under section 164(d). For illustrations of the application of this paragraph, see § 1.1001-1(b).

(c) [Reserved.]

(d) *Special rules.*—For special rules for determining the basis for gain or loss in the case of vessels acquired through the Maritime

Commission (or its successor), see sections 510 and 511 of the Merchant Marine Act of 1936 (46 U. S. C. 1160, 1161). For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 1336. For special rules for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see section 421(b). For special rules for determining the basis and adjusted basis of property acquired or improved with the proceeds of a grant or loan made to a taxpayer by the United States for the encouragement of exploration, development, or mining of critical and strategic minerals or metals, see section 621.

§ 1.1012-2 TRANSFERS IN PART A SALE AND IN PART A GIFT.—For rule relating to basis of property acquired in a transfer which is in part a gift and in part a sale, see § 1.1015-4.

§ 1.1013 STATUTORY PROVISIONS; BASIS OF PROPERTY INCLUDED IN INVENTORY.

SEC. 1013. BASIS OF PROPERTY INCLUDED IN INVENTORY.

If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

§ 1.1013-1 PROPERTY INCLUDED IN INVENTORY.—The basis of property required to be included in inventory is the last inventory value of such property in the hands of the taxpayer. The requirements with respect to the valuation of an inventory are stated in sections 471, 472, and the regulations thereunder.

§ 1.1014 STATUTORY PROVISIONS; BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) IN GENERAL.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

(b) PROPERTY ACQUIRED FROM THE DECEDENT.—For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

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(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

(7) In the case of decedents dying after October 21, 1942, and on or before December 31, 1947, such part of any property, representing the surviving spouse's one-half share of property held by a decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the gross estate of the decedent, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable on the transfer of the net estate of the decedent. In such case, nothing in this paragraph shall reduce the basis below that which would exist if the Revenue Act of 1948 had not been enacted;

(8) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of such interest was required to be included in determining the value of decedent's gross estate under section 811 of the Internal Revenue Code of 1939;

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) annuities described in section 72;

(B) property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) property described in any other paragraph of this subsection.

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT.—This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

(d) EMPLOYEE STOCK OPTIONS.—This section shall not apply to restricted stock options described in section 421 which the employee has not exercised at death.

§ 1.1014-1 BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.—(a) *General rule.*—The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate

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tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see § 1.1014-3(e).

(b) *Scope and application.*—With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of § 1.1014-2. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in § 1.1014-2(c). These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§ 1.1014-2 to 1.1014-6, inclusive, whenever the words "property acquired from a decedent" are used they shall also mean "property passed from a decedent" and the phrase "person who acquired it from the decedent" shall include the "person to whom it passed from the decedent."

(c) *Property to which section 1014 does not apply.*—Section 1014 shall have no application to the following classes of property:

- (1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and
- (2) Restricted stock options described in section 421 which the employee has not exercised at death, regardless of the date on which the employee died.

§ 1.1014-2 PROPERTY ACQUIRED FROM A DECEDENT.—(a) *In general.*—The following property, except where otherwise indicated, is considered to have been acquired from a decedent and the basis thereof is determined in accordance with the general rule in § 1.1014-1:

- (1) Without regard to the date of the decedent's death, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents. However, see paragraph (c)(1) of this section if the property was acquired by bequest or inheritance from a § 1.1014-1(b)

decedent dying after August 26, 1937, and if such property consists of stock or securities of a foreign personal holding company.

(2) Without regard to the date of the decedent's death, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(4) Without regard to the date of the decedent's death, property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. (See section 2041(b) for definition of general power of appointment.)

(5) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in that property was includible in determining the value of the decedent's gross estate under part III of chapter 11 (relating to the estate tax) or section 811 of the Internal Revenue Code of 1939. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(6) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of that interest was required to be included in determining the value of the decedent's gross estate under section 811 of chapter 3 of the Internal Revenue Code of 1939. It is necessary only that the value of a part of the survivor's interest in the annuity be includible in the gross estate under section 811. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(b) *Property acquired from a decedent dying after December 31, 1953.*—(1) *In general.*—In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) the property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in § 1.1014-1. See,

however, § 1.1014-6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) for a description of property not within the scope of this paragraph.

(2) *Rules for the application of subparagraph (1).*—Except as provided in subparagraph (3), this paragraph generally includes all property acquired from a decedent, which is includible in the gross estate of the decedent if the decedent died after December 31, 1953. It is not necessary for the application of this paragraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph. Also, this paragraph includes property acquired through the exercise or nonexercise of a power of appointment where such property is includible in the decedent's gross estate. It does not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States.

(3) *Exceptions to application of paragraph (b).*—The rules in paragraph (b) are not applicable to the following property:

(i) Annuities described in section 72;

(ii) Stock or securities of a foreign personal holding company as described in section 1014(b)(5) (see paragraph (c)(1) of this section);

(iii) Property described in any paragraph other than paragraph (9) of section 1014(b). See paragraphs (a) and (c) of this section. In illustration of subdivision (ii), assume that A acquired by gift stock of a character described in paragraph (c)(1) of this section from a donor and upon the death of the donor the stock was includible in the donor's estate as being a gift in contemplation of death. A's basis in the stock would not be determined by reference to its fair market value at the donor's death under the general rule in section 1014(a). Furthermore, the special basis rules prescribed in paragraph (c)(1) are not applicable to such property acquired by gift in contemplation of death. It will be necessary to refer to the rules in section 1015(a) to determine the basis.

(c) *Special basis rules with respect to certain property acquired from a decedent.*—(1) *Stock or securities of a foreign personal holding company.*—The basis of certain stock or securities of a foreign corporation which was a foreign personal holding company with respect to its taxable year next preceding the date of the decedent's death is governed by a special rule. If such stock was acquired from a decedent dying after August 26, 1937, by bequest or inheritance, or by the decedent's estate from the decedent, the basis of the property in the hands of the person who so acquired it (notwithstanding any other provision of section 1014) shall be the fair market value of such property at the date of the decedent's death or the adjusted basis of the stock in the hands of the decedent, whichever is lower.

(2) *Spouse's interest in community property of decedent dying after October 21, 1942, and on or before December 31, 1947.*—In the

§ 1.1014-2(b)(2)

case of a decedent dying after October 21, 1942, and on or before December 31, 1947, a special rule is provided for determining the basis of such part of any property, representing the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the decedent's gross estate, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable upon the decedent's net estate. In such case the basis shall be the fair market value of such part of the property at the date of death (or the optional valuation elected under section 811 (j) of the Internal Revenue Code of 1939) or the adjusted basis of the property determined without regard to this subparagraph, whichever is the higher.

§ 1.1014-3 OTHER BASIS RULES.—(a) *Fair market value*.—For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939) the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

(b) *Property acquired from a decedent dying before March 1, 1913*.—If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 1053.

(c) *Reinvestments by a fiduciary*.—The basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value of such property at the death of the decedent. For example, the executor of an estate purchases stock of X company at a price of \$100 per share with the proceeds of the sale of property acquired from a decedent. At the date of the decedent's death the fair market value of such stock was \$98 per share. The basis of such stock to the executor or to a legatee, assuming the stock is distributed, is \$100 per share.

(d) *Reinvestments of property transferred during life*.—Where property is transferred by a decedent during life and the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent, the general rule stated in § 1.1014-1 (a) shall not apply to such property. However, in such a case, the basis of any property acquired by such donee in exchange for the original property, or of any property acquired by the donee through reinvesting the proceeds of the sale of the original property, shall be the fair market value of the property thus acquired at the date of the decedent's death (or applicable alternate valuation date) if the property thus acquired is

properly included in the decedent's gross estate for Federal estate tax purposes. These rules also apply to property acquired by the donee in any further exchanges or in further reinvestments. For example, on January 1, 1956, the decedent made a gift of real property to a trust for the benefit of his children, reserving to himself the power to revoke the trust at will. Prior to the decedent's death the trustee sold the real property and invested the proceeds in stock of the Y Company at \$50 per share. At the time of the decedent's death the value of such stock was \$75 per share. The corpus of the trust was required to be included in the decedent's gross estate owing to his reservation of the power of revocation. The basis of the Y Company stock following the decedent's death is \$75 per share. Moreover, if the trustee sold the Y Company stock before the decedent's death for \$65 a share and reinvested the proceeds in Z Company stock which increased in value to \$85 per share at the time of the decedent's death, the basis of the Z Company stock following the decedent's death would be \$85 per share.

(e) *Alternate valuation dates.*—Section 1014(a) provides a special rule applicable in determining the basis of property described in § 1.1014-2 where—

(1) The property is includible in the gross estate of a decedent who died after October 21, 1942, and

(2) The executor elects for estate tax purposes under section 2032, or section 811 (j) of the Internal Revenue Code of 1939 to value the decedent's gross estate at the alternate valuation date prescribed in such sections.

In those cases, the value applicable in determining the basis of the property is not the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death if not distributed, sold, exchanged, or otherwise disposed of in the meantime. If such property was distributed, sold, exchanged, or otherwise disposed of within one year after the date of the decedent's death by the person who acquired it from the decedent, the value applicable in determining the basis is its value as of the date of such distribution, sale, exchange, or other disposition. For illustration of the operation of this paragraph, see the estate tax regulations under section 2032.

§ 1.1014-4 UNIFORMITY OF BASIS; ADJUSTMENT TO BASIS.—(a) *In general.*—(1) The basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. In determining the amount allowed or allowable to a taxpayer in computing taxable income as deductions for depreciation or depletion under section 1016(a) (2), the uniform basis of the property shall at all times be used and adjusted. The sale, ex-

§ 1.1014-3(e)

change, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition.

(2) Under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise. Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014, and, for this reason, a common or uniform basis for all such interests. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property. If the bequest is of the residue to trustee in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies. If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died. The purpose of the Internal Revenue Code in prescribing a general uniform basis rule for property acquired from a decedent is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstance that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which is recognized as the measure of gain or loss.

(3) The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a

basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of \$10,000, securities which had a fair market value of \$9,000 on the date of the decedent's death (the applicable valuation date) and \$10,000 on the date of the transfer, the trust realizes a taxable gain of \$1,000 and the basis of the securities in the hands of the beneficiary would be \$10,000. As a further example, if the executor of an estate transfers to a trust property worth \$200,000, which had a fair market value of \$175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of \$25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be \$200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternative valuation date.

(b) *Multiple interests*.—Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis for computing gain or loss on the sale of any one of such multiple interests shall be determined under § 1.1014-5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See § 1.1014-6 for adjustments in respect of property acquired from a decedent prior to his death.

(c) *Records*.—The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions,

or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require.

§ 1.1014-5 GAIN OR LOSS.—(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.*—(1) The gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II of subchapter O of chapter 1 of the Internal Revenue Code of 1954. The proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time. Where a remainder interest is subject to a life interest in one person only, the factors set forth in the table which appears at the end of this subparagraph shall be used in determining the basis of the life interest or the remainder interest in the property at the time such interest is sold. The basis of the life interest or the remainder interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor which appears in the life interest or the remainder interest column of the table opposite the age (at the time of the sale) of the person at whose death the life interest will terminate.

TABLE OF FACTORS

(These factors are taken from Table I of the Estate Tax Regulations. See Table I in § 20.2031-7 (f) of those regulations for remainder and life factors for ages not shown here.)

Age of measuring life	Factor for life interest	Factor for remainder interest	Age of measuring life	Factor for life interest	Factor for remainder interest
21	0.78203	0.21797	32	0.70245	0.29755
22	.77576	.22424	33	.69401	.30599
23	.76930	.23070	34	.68536	.31464
24	.76266	.23734	35	.67650	.32350
25	.75582	.24418	36	.66743	.33257
26	.74880	.25120	37	.65815	.34185
27	.74157	.25843	38	.64867	.35133
28	.73416	.26584	39	.63898	.36102
29	.72653	.27347	40	.62908	.37092
30	.71871	.28129	41	.61899	.38101
31	.71068	.28932	42	.60869	.39131



TABLE OF FACTORS—Continued

(These factors are taken from Table I of the *Estate Tax Regulations*. See Table I in § 20.2031-7 (f) of those regulations for remainder and life factors for ages not shown here.)

Age of measuring life	Factor for life interest	Factor for remainder interest	Age of measuring life	Factor for life interest	Factor for remainder interest
43	0.59820	0.40180	62	0.37165	0.62835
44	.58751	.41249	63	.35911	.64089
45	.57664	.42336	64	.34663	.65337
46	.56559	.43441	65	.33420	.66580
47	.55436	.44564	66	.32186	.67814
48	.54297	.45703	67	.30962	.69038
49	.53141	.46859	68	.29750	.70250
50	.51970	.48030	69	.28552	.71448
51	.50785	.49215	70	.27370	.72630
52	.49587	.50413	71	.26205	.73795
53	.48377	.51623	72	.25059	.74941
54	.47157	.52843	73	.23934	.76066
55	.45926	.54074	74	.22831	.77169
56	.44688	.55312	75	.21752	.78248
57	.43442	.56558	76	.20698	.79302
58	.42191	.57809	77	.19670	.80330
59	.40936	.59064	78	.18671	.81329
60	.39679	.60321	79	.17700	.82300
61	.38422	.61578	80	.16759	.83241

In cases in which the value of an interest cannot be determined from the above table, for example, cases in which the interest to be valued is dependent upon the continuation or termination of more than one life, or there is a term-certain concurrent with one or more lives, the factor is to be computed upon the basis of the Makehamized mortality table and interest at the rate of  $3\frac{1}{2}$  percent a year, compounded annually. This table appears as Table 38 of United States Life Tables and Actuarial Tables 1939-1941, published by the United States Department of Commerce, Bureau of the Census. Many such factors may be found in, or readily computed with the use of the tables contained in a pamphlet entitled "Actuarial Values for Estate and Gift Tax," which may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington 25, D. C.; or a case requiring a special factor (provided the transaction is completed and not merely proposed or hypothetical) may be stated to the Commissioner who will furnish such factor. The request must be accompanied by a statement of the date of birth of each person, the duration of whose life may affect the value of the interest, and by copies of the relevant instruments.

(2) The application of this section may be illustrated by the following example:

*Example.* Improved realty having a fair market value of \$20,000 at the date of the decedent's death on January 1, 1954, is devised to A for life, with remainder over to B. On January 1, 1958, A sells his life interest for \$12,500. During each of the years 1954-1957, inclusive, A was allowed a deduction of \$300 for depreciation. Thus, the adjusted uniform basis of the property is \$18,800 (\$20,000 minus \$1,200 depreciation). At the time of the sale, A was 39 years of age.

The life factor to be used here is 0.63898. The portion of the uniform basis (adjusted to the time of the sale) assigned to A's life interest is \$12,012.82 ( $0.63898 \times \$18,800$ ). A's gain on the sale is \$187.18 ( $\$12,500 - \$12,012.82$ ).

§ 1.1014-6 SPECIAL RULE FOR ADJUSTMENTS TO BASIS WHERE PROPERTY IS ACQUIRED FROM A DECEDENT PRIOR TO HIS DEATH.—(a) *In general.*—(1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016(a)(2)(B) to the taxpayer as deductions for exhaustion, wear and tear, obsolescence, amortization and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that of the year prior to his death. For a discussion of the basis adjustment required by section 1014(b)(9) where property is held in trust, see paragraph (c) of this section.

(2) Where property coming within the purview of subparagraph (1) of this paragraph was held by the decedent and his surviving spouse as tenants by the entirety or as joint tenants with right of survivorship, and joint income tax returns were filed by the decedent and the surviving spouse in which the deductions referred to in subparagraph (1) were taken, there shall be allocated to the surviving spouse's interest in the property that proportion of the deductions allowed for each period for which the joint returns were filed which her income from the property bears to the total income from the property. Each spouse's income from the property shall be determined in accordance with local law.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of \$50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of \$750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of \$500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is \$49,000 (\$50,000, the fair market value at the decedent's death, less \$1,000, the total of the amounts actually allowed as deductions).

*Example (2).* On July 1, 1951, H purchased for \$30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was

\$40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was \$500 and for each of the other years 1953 and 1954 was \$1,000. One-half of the \$2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was \$38,750 (\$40,000, value on the date of H's death, less \$1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be \$40,000.

(b) *Multiple interests in property described in section 1014(b) (9) and acquired from a decedent prior to his death.*—(1) Where more than one person has an interest in property described in section 1014(b) (9) which was acquired from a decedent before his death, the basis of such property and of each of the several interests therein shall, in general, be determined and adjusted in accordance with the principles contained in §§ 1.1014-4 and 1.1014-5, relating to the uniformity of basis rule. Application of these principles to the determination of basis under section 1014(b) (9) is shown in the remaining subparagraphs of this paragraph in connection with certain commonly encountered situations involving multiple interests in property acquired from a decedent before his death.

(2) Where property is acquired from a decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, the uniform basis of the property, as well as the basis of each of the several interests in the property, shall be determined by taking into account the basis adjustments required by section 1014(a) owing to such inclusion of the entire property in the decedent's gross estate. For example, suppose that the decedent transfers property in trust, with a life estate to A, and the remainder to B or his estate. The transferred property consists of 100 shares of the common stock of X Corporation, with a basis of \$10,000 at the time of the transfer. At the time of the decedent's death the value of the stock is \$20,000. The transfer is held to have been made in contemplation of death and the entire value of the trust is included in the decedent's gross estate. Under section 1014(a), the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, is \$20,000. If immediately prior to the decedent's death, A's share of the uniform basis of \$10,000 was \$6,000, and B's share was \$4,000, then, immediately after the decedent's death, A's share of the uniform basis of \$20,000 is \$12,000, and B's share is \$8,000.

(3) (i) In cases where, due to the operation of the estate tax, only a portion of property acquired from a decedent before his death is included in the decedent's gross estate, as in cases where the decedent retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property shall be determined by taking into account any basis adjustments required by section 1014(a) owing to such inclusion of a portion of the property in the decedent's gross estate. In such cases the uniform basis is the

adjusted basis of the entire property immediately prior to the decedent's death increased (or decreased) by an amount which bears the same relation to the total appreciation (or diminution) in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. For example, assume that the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent should survive A, the income shall be paid to the decedent for life. Assume that the decedent pre-deceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the common stock of X Corporation with an adjusted basis immediately prior to the decedent's death of \$10,000 (as determined under section 1015). At the time of the decedent's death the value of the stock is \$20,000, and the value of the remainder interest in the hands of B is \$8,000. The uniform basis of the entire property following the decedent's death is \$14,000, computed as follows:

Uniform basis prior to decedent's death .....	\$10,000
plus	
Increase in uniform basis (determined by the following formula) .....	4,000
Increase in uniform basis (to be determined)	\$8,000 (value of property included in gross estate)
<u>\$10,000 (total appreciation)</u>	<u>\$20,000 (value of entire property)</u>
Uniform basis under section 1014(a) .....	\$14,000

(ii) In cases of the type described in subdivision (i) of this subparagraph, the basis of any interest which is included in the decedent's gross estate may be ascertained by adding to (or subtracting from) the basis of such interest determined immediately prior to the decedent's death the increase (or decrease) in the uniform basis of the property attributable to the inclusion of the interest in the decedent's gross estate. Where the interest is sold or otherwise disposed of at any time after the decedent's death, proper adjustment must be made in order to reflect the change in value of the interest on account of the passage of time (see § 1.1014-5(a) and the table included therein). For an illustration of the operation of this subdivision, see step 6 of the example in § 1.1014-7.

(iii) In cases of the type described in subdivision (i) (cases where, due to the operation of the estate tax, only a portion of the property is included in the decedent's gross estate), the basis for computing the depreciation, amortization, or depletion allowance shall be the uniform basis of the property determined under section 1014(a). However, the manner of taking into account such allowance computed with respect to such uniform basis is subject to the following limitations:

(a) In cases where the value of the life interest is not included in the decedent's gross estate, the amount of such allowance to the life tenant under section 167(g) (or section 611(b)) shall not exceed (or

be less than) the amount which would have been allowable to the life tenant if no portion of the basis of the property was determined under section 1014(a). Proper adjustment shall be made for the amount allowable to the life tenant, as required by section 1016. Thus, an appropriate adjustment shall be made to the uniform basis of the property in the hands of the trustee, to the basis of the life interest in the hands of the life tenant, and to the basis of the remainder in the hands of the remainderman.

(b) Any remaining allowance (that is, the increase in the amount of depreciation, amortization, or depletion allowable resulting from any increase in the uniform basis of the property under section 1014(a)) shall not be allowed to the life tenant. The remaining allowance shall, instead, be allowed to the trustee to the extent that the trustee both (1) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion and (2) actually maintains such a reserve. If, in accordance with the preceding sentence, the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under section 1016, in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainderman, but shall not be taken into account, under section 1016, in determining the basis of the life interest in the hands of the life tenant. For an example of the operation of this subdivision, see § 1.1014-7(b).

(4) In cases where the basis of any interest in property is not determined under section 1014 (a), as where such interest (i) is not included in the decedent's gross estate, or (ii) is sold, exchanged or otherwise disposed of before the decedent's death, the basis of such interest shall be determined under other applicable provisions of the Internal Revenue Code. To illustrate, in the example shown in subdivision (i) of subparagraph (3) of this paragraph the basis of the life estate in the hands of A shall be determined under section 1015, relating to the basis of property acquired by gift. If, on the other hand, A had sold his life interest prior to the decedent's death, the basis of the life estate in the hands of A's transferee would be determined under section 1012.

(c) *Adjustments for deductions allowed prior to the decedent's death.*—(1) As stated in paragraph (a), section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014(b)(9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

(2) The application of this paragraph may be illustrated by the following examples:

*Example (1).* The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The property transferred in trust consists of an apartment building with a basis of \$50,000 at the time of the transfer. The decedent dies 2 years after the transfer is made and the gift is held to have been made in contemplation of death. Depreciation on the property was allowed in the amount of \$1,000 annually. At the time of the decedent's death the value of the property is \$58,000. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, immediately after the decedent's death is \$56,000 (\$58,000, fair market value of the property immediately after the decedent's death, reduced by \$2,000, deductions for depreciation allowed prior to the decedent's death).

*Example (2).* The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent predeceases A and the present value of the remainder interest is included in the decedent's gross estate for estate tax purposes. The property transferred consists of an apartment building with a basis of \$110,000 at the time of the transfer. Following the creation of the trust and during the balance of the decedent's life, deductions for depreciation were allowed on the property in the amount of \$10,000. At the time of decedent's death the value of the entire property is \$150,000, and the value of the remainder interest is \$100,000. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, as adjusted under section 1014(b) (9), is \$126,666, computed as follows:

Uniform basis prior to decedent's death .....	\$100,000	
plus		
Increase in uniform basis—before reduction (determined by the following formula) .....		33,333
Increase in uniform basis (to be determined) .....	\$100,000 (value of property included in gross estate)	
\$50,000 (total appreciation of property since time of transfer) .....	\$150,000 (value of entire property)	
		<hr/>
		\$133,333
less		
Deductions allowed prior to decedent's death—taken into account under sec. 1014(b) (9) (determined by the following formula) .....		6,667
Prior deductions taken into account (to be determined) .....	\$100,000 (value of property included in gross estate)	
\$10,000 (total deductions allowed prior to decedent's death) .....	\$150,000 (value of entire property)	
		<hr/>
Uniform basis under section 1014 .....		\$126,666

§ 1.1014-7 EXAMPLE APPLYING RULES OF §§ 1.1014-4 THROUGH 1.1014-6 TO CASE INVOLVING MULTIPLE INTERESTS.—

(a) On January 1, 1950, the decedent creates a trust to pay the

§ 1.1014-7(a)

income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent, who died on January 1, 1955, predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is scheduled in the decedent's gross estate. The trust consists of an apartment building with a basis of \$30,000 at the time of transfer. Under the trust instrument the trustee is required to maintain a reserve for depreciation. During the decedent's lifetime, depreciation is allowed in the amount of \$800 annually. At the time of the decedent's death the value of the apartment building is \$45,000. A, the life tenant, is 43 years of age at the time of the decedent's death. Immediately after the decedent's death, the uniform basis of the entire property under section 1014(a) is \$32,027; A's basis for the life interest is \$15,553; and B's basis for the remainder interest is \$16,474, computed as follows:

*Step 1.* Uniform basis (adjusted) immediately prior to decedent's death:

Basis at time of transfer .....	\$30,000
less	
Depreciation allowed under section 1016 before decedent's death (\$800×5) .....	4,000
	<hr/>
	\$26,000

*Step 2.* Value of property included in decedent's gross estate:

$$0.40180 \text{ (remainder factor, age 43)} \times \$45,000 \text{ (value of entire property)} = \$18,081$$

*Step 3.* Uniform basis of property under section 1014(a), before reduction required by section 1014(b) (9)

Uniform basis (adjusted) prior to decedent's death .....	\$26,000
Increase in uniform basis (determined by the following formula) .....	7,634
Increase in uniform basis (to be determined) .....	\$18,081 (value of property included in gross estate)
<hr/>	<hr/>
\$19,000 (total appreciation, \$45,000—\$26,000) .....	\$45,000 (value of entire property)
	<hr/>
	\$33,634

*Step 4.* Uniform basis reduced as required by section 1014(b) (9) for deductions allowed prior to death:

Uniform basis before reduction .....	\$33,634
less	
Deductions allowed prior to decedent's death—taken into account under section 1014(b) (9) (determined by the following formula) .....	1,607
Prior deductions taken into account (to be determined) .....	\$18,081 (value of property included in gross estate)
<hr/>	<hr/>
\$1,000 (total deductions allowed prior to decedent's death) .....	\$45,000 (value of entire property)
	<hr/>
	\$32,027

*Step 5.* A's basis for the life interest at the time of the decedent's death, determined under section 1015:

$$0.59820 \text{ (life factor, age 43)} \times 26,000 = \$15,553$$

*Step 6.* B's basis for the remainder interest, determined under section 1014(a):

Basis prior to the decedent's death:

0.40180 (remainder factor, age 43) × \$26,000 ..... = \$10,447  
plus

Increase in uniform basis owing to decedent's death:

Increase in uniform basis ..... \$7,634

Reduction required by section 1014(b)(9) ..... 1,607

6,027

\$16,474

(b) Assume the same facts as in (a). Assume further, that following the decedent's death, depreciation is allowed in the amount of \$1,000 annually. As of January 1, 1964, when A's age is 52, the adjusted uniform basis of the entire property is \$23,027; A's basis for the life interest is \$9,323; and B's basis for the remainder interest is \$13,704, computed as follows:

Step 7. Uniform basis (adjusted) as of January 1, 1964:

Uniform basis determined under section 1014(a), reduced as required by section 1014(b)(9) ..... \$32,027

less

Depreciation allowed since decedent's death (\$1,000 × 9) ..... 9,000

\$23,027

Step 8. Allocable share of adjustment for depreciation allowable in the nine years since the decedent's death:

*A's interest*

0.49587 (life factor, age 52) × \$7,200 (800, depreciation attributable to uniform basis before increase under section 1014(a), × 9) ..... = \$3,570

*B's interest*

0.50413 (remainder factor, age 52) × \$7,200 (800, depreciation attributable to uniform basis before increase under section 1014(a), × 9) ..... = 3,630

plus

\$200 (annual depreciation attributable to increase in uniform basis under section 1014(a)) × 9 ..... = 1,800

\$5,430

Step 9. Tentative bases of A's and B's interests as of January 1, 1964 (before adjustment for depreciation):

*A's interest*

0.49587 (life factor, age 52) × \$26,000 (adjusted uniform bases immediately before decedent's death) ..... = \$12,893

*B's interest*

0.50413 (remainder factor, age 52) × \$26,000 (adjusted uniform basis immediately before decedent's death) ..... = 13,107

plus

Increase in uniform basis owing to inclusion of remainder in decedent's gross estate ..... 6,027

\$19,134

Step 10. Bases of A's and B's interests as of January 1, 1964

*A*

Tentative basis (Step 9) ..... \$12,893

less

Allocable depreciation (Step 8) ..... 3,570

\$9,323



## B

Tentative basis (Step 9) .....	19,134
less	
Allocable depreciation (Step 8) .....	5,430
	<hr/> \$13,704

§ 1.1014-8 BEQUEST, DEVISE, OR INHERITANCE OF A REMAINDER INTEREST.—(a) (1) Where property is transferred for life, with remainder in fee, and the remainderman dies before the life tenant, no adjustment is made to the uniform basis of the property on the death of the remainderman (see § 1.1014-4(a)). However, the basis of the remainderman's heir, legatee, or devisee for the remainder interest is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest (determined in accordance with the principles set forth in §§ 1.1014-4 through 1.1014-6) the difference between—

(i) The value of the remainder interest included in the remainderman's estate, and

(ii) The basis of the remainder interest immediately prior to the remainderman's death.

(2) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) shall be determined by adding to (or subtracting from) the adjusted uniform basis of the property thus distributed the difference between—

(i) The value of the remainder interest in the property included in the remainderman's estate, and

(ii) The basis of the remainder interest in the property immediately prior to the remainderman's death.

(b) The provisions of paragraph (a) of this section are illustrated by the following examples:

*Example (1).* Assume that, under the will of a decedent, property consisting of common stock with a value of \$1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is \$1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is \$547 (0.34185, remainder factor age 37,  $\times$  \$1,600), and hence \$547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is \$596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.30131, remainder factor age 42, $\times$ \$1,000, uniform basis of entire property) .....	\$391
plus	
Value of remainder interest included in B's estate .....	\$547

§ 1.1014-8(a)(1)

less

Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37×\$1,000) .....	342	205
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Basis of C's remainder interest at the time of sale .....		\$596
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*Example (2).* Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust .....		\$1,000
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plus

Value of remainder interests in the property at the time of B's death .....	\$547	
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B's share of uniform basis of the property at the time of his death .....	342	205
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less

C's basis for the stock distributed to him upon the termination of the trust .....		\$1,205
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*Example (3).* Assume the same facts as in example (2), except that the property transferred is depreciable. Assume further that \$100 of depreciation was allowed prior to B's death and that \$50 of depreciation is allowed between the time of B's death and the termination of the trust. Upon A's death terminating the trust, C's basis for the property distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust:		
--	--	--

Uniform basis immediately after decedent's death .....	\$1,000	
--	---------	--

Depreciation allowed following decedent's death .....	150	\$850
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plus

Value of remainder interest in the property at the time of B's death .....	\$547	
--	-------	--

less

B's share of uniform basis of the property at the time of his death (0.34185×\$900, uniform basis at B's death) .....	308	230
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C's basis for the property distributed to him upon the termination of the trust .....		\$1,089
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(c) The rules stated in paragraph (a) do not apply where the basis of the remainder interest in the hands of the remainderman's transferee is determined by reference to its cost to such transferee. See also, § 1.1014-4(a). Thus, if, in example (1) of the preceding paragraph, B sold his remainder interest to C for \$547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is \$547.

## § 1.1015 STATUTORY PROVISIONS; BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

### SEC. 1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

(a) GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in

the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary or his delegate shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obtain, such property was acquired by such donor or last preceding owner.

(b) **TRANSFER IN TRUST AFTER DECEMBER 31, 1920.**—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.

(c) **GIFT OR TRANSFER IN TRUST BEFORE JANUARY 1, 1921.**—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

§ 1.1015-1 **BASIS OF PROPERTY ACQUIRED BY GIFT AFTER DECEMBER 31, 1920.**—(a) *General rule.*—(1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise) the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) may be illustrated by the following example:

*Example.* A acquires by gift income-producing property which has an adjusted basis of \$100,000 at the date of gift. The fair market value of the property at the date of gift is \$90,000. A later sells the property for \$95,000. In such case there is neither gain nor loss. The basis for determining loss is \$90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is \$100,000.

(b) *Uniform basis; proportionate parts of.*—Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5.

§ 1.1015-1(a)(1)

(c) *Time of acquisition*.—The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Thus, the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.

(d) *Property acquired by gift from a decedent dying after December 31, 1953*.—If an interest in property was acquired by the taxpayer by gift from a donor dying after December 31, 1953, under conditions which require the inclusion of the property in the donor's gross estate for estate tax purposes, and the property had not been sold, exchanged, or otherwise disposed of by the taxpayer before the donor's death, see the rules prescribed in section 1014 and the regulations thereunder.

(e) *Fair market value*.—For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, shall be deemed to be the fair market value of the property at the time of the gift.

(f) *Reinvestments by fiduciary*.—If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

(g) *Records*.—To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift.

§ 1.1015-2 TRANSFER OF PROPERTY IN TRUST AFTER DECEMBER 31, 1920.—(a) *General rule*.—(1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in § 1.1015-1(b) concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

(b) *Reinvestment by fiduciary*.—If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the

fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

§ 1.1015-3 GIFT OR TRANSFER IN TRUST BEFORE JANUARY 1, 1921.—

(a) In the case of property acquired by gift or transfer in trust before January 1, 1921, the basis of such property is the fair market value thereof at the time of the gift or at the time of the transfer in trust.

(b) The principles stated in § 1.1015-1 (b) concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by gift or transfer in trust before January 1, 1921. In addition, if an interest in such property was acquired from a decedent and the property had not been sold, exchanged, or otherwise disposed of before the death of the donor, the rules prescribed in section 1014 and the regulations thereunder are applicable in determining the basis of such property in the hands of the taxpayer.

§ 1.1015-4 TRANSFERS IN PART A GIFT AND IN PART A SALE.—(a)

*General rule.*—Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of (1) the amount paid by the transferee for the property, and (2) any excess of the transferor's adjusted basis over such amount. Thus, the unadjusted basis of the property in the hands of the transferee is the greater of (1) the amount paid for the property, or (2) the transferor's adjusted basis at the time of the transfer. For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor see § 1.1001-1 (e).

(b) *Examples.*—The rule of paragraph (a) is illustrated by the following examples:

*Example (1).* If A transfers property to his son for \$30,000, and such property at the time of the transfer has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$60,000), the unadjusted basis of the property in the hands of the son is \$30,000.

*Example (2).* If A transfers property to his son for \$60,000, and such property at the time of transfer has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000.

*Example (3).* If A transfers property to his son for \$30,000, and such property at the time of transfer has an adjusted basis in A's hands of \$60,000 (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000.

*Example (4).* If A transfers property to his son for \$30,000 and such property at the time of transfer has an adjusted basis of \$90,000 in A's hands (and a fair market value of \$60,000), the unadjusted basis of the property in the hands of the son is \$90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at the time, for the purpose of determining any loss on a later sale or disposition of the property by the son its unadjusted basis and is \$60,000.

## § 1.1016 STATUTORY PROVISIONS; ADJUSTMENTS TO BASIS.

## SEC. 1016. ADJUSTMENTS TO BASIS.

(a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable, to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws, but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167(b)(1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020. Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913, and

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) in the case of any bond (as defined in section 171(d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171(a)(2), and in the case of any other bond (as defined in section 171(d)) to the extent of the deductions allowable pursuant to section 171(a)(1) with respect thereto;

(6) in the case of any short-term municipal bond (as defined in section 75(b)), to the extent provided in section 75(a)(2);

(7) in the case of a residence the acquisition of which resulted, under section 1034, in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034(e);

(8) in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year

in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) for amounts allowed as deductions as deferred expenses under section 616(b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(10) for amounts allowed as deductions as deferred expenses under section 615(b) (relating to certain exploration expenditures) and resulting in a reduction of the taxpayer's taxes under this subtitle but not less than the amounts allowable under such section for the taxable year and prior years;

(11) for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12) to the extent provided in section 28(h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

(13) to the extent provided in section 551(f) in the case of the stock of United States shareholders in a foreign personal holding company;

(14) for amounts allowed as deductions as deferred expenses under section 174(b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) for deductions to the extent disallowed under section 272 (relating to disposal of coal), notwithstanding the provisions of any other paragraph of this subsection.

(b) **SUBSTITUTED BASIS.**—Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in subsection (a) shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases. The term "substituted basis" as used in this section means a basis determined under any provision of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses), or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(1) by reference to the basis in the hands of a transferor, donor, or grantor, or

(2) by reference to other property held at any time by the person for whom the basis is to be determined.

(c) **SEPARATE MINERAL INTERESTS TREATED AS ONE PROPERTY.**—For treatment of separate mineral interests as one property, see section 614.

§ 1.1016-1 **ADJUSTMENTS TO BASIS; SCOPE OF SECTION.**—Section 1016 and §§ 1.1016-2 to 1.1016-10, inclusive, contain the rules relating to the adjustments to be made to the basis of property to determine

account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263(c).

(b) The application of the foregoing provisions may be illustrated by the following example:

*Example.* A, who makes his returns on the calendar year basis, purchased property in 1941 for \$10,000. He subsequently expended \$6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is \$16,000. If A sells the property in 1954 for \$20,000, the amount of his gain will be \$4,000.

(c) Adjustment to basis shall be made for carrying charges such as taxes and interest, with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive), which the taxpayer elects to treat as chargeable to capital account under section 266, rather than as an allowable deduction. The term "taxes" for this purpose includes duties and excise taxes but does not include income taxes.

(d) Expenditures described in section 173 to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical are chargeable to capital account only in accordance with and in the manner provided in the regulations under section 173.

§ 1.1016-3 EXHAUSTION, WEAR AND TEAR, OBSOLESCENCE, AMORTIZATION, AND DEPLETION FOR PERIODS SINCE FEBRUARY 28, 1913.—(a) *In general.*—(1) *Adjustment where deduction is claimed.*—(i) For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of the following two amounts: (a) the amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or (b) the amount allowable for the years involved. See paragraph (b) of this section. Where the taxpayer makes an appropriate election the above rule is applicable for periods since February 28, 1913, and before January 1, 1952. See paragraph (d) of this section. For rule for such periods where no election is made, see paragraph (c) of this section.

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years shall not be



increased even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement of depreciable property, including rules for determining basis, see § 1.167(a)-8 of the regulations under section 167. This subdivision may be illustrated by the following example:

*Example.* An asset was purchased January 1, 1950, at a cost of \$10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1950 to 1954 as follows:

1950 .....	\$500
1951 .....	.....
1952 .....	1,000
1953 .....	1,000
1954 .....	1,000
Total amount allowed .....	\$3,500

The correct reserve as of December 31, 1954, is computed as follows:

Dec. 31:	
1950 ( $\$10,000 \div 10$ ) .....	\$1,000
1951 ( $\$9,000 \div 9$ ) .....	1,000
1952 ( $\$8,000 \div 8$ ) .....	1,000
1953 ( $\$7,000 \div 7$ ) .....	1,000
1954 ( $\$6,000 \div 6$ ) .....	1,000
Reserve Dec. 31, 1954 .....	\$5,000

Depreciation for 1955 is computed as follows:

Cost .....	\$10,000
Reserve as of December 31, 1954 .....	5,000
Unrecovered cost .....	\$5,000
Depreciation allowable for 1955 ( $\$5,000 \div 5$ ) .....	1,000

(2) *Adjustment for amount allowable where no depreciation deduction claimed.*—(i) If the taxpayer has not taken a depreciation deduction either in the taxable year or for any prior taxable year, adjustments to basis of the property for depreciation allowable shall be determined by using the straight-line method of depreciation. (See § 1.1016-4 for adjustments in the case of persons exempt from income taxation.)

(ii) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, if the taxpayer with respect to any property has taken a deduction for depreciation properly under one of the methods provided in section 167(b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable in such a case will be the deduction under the method which was used by the taxpayer with respect to that property. Thus, if A acquired property in 1954 on which he properly computed his depreciation deduction under the method described in section 167(b) (2) (the declining-balance method) for the first year of its useful life but did not take a deduction in the second and third year of the asset's life, the adjustment to basis for depreciation allowable for the second and third year will be likewise computed under the declining-balance method.

(3) *Adjustment for depletion deductions with respect to taxable years before 1932.*—Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall not exceed a depletion deduction which would have been allowable for such year if computed without reference to discovery value or a percentage of income.

(b) *Adjustment for periods beginning on or after January 1, 1952.*—The decrease required by paragraph (a) of this section for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing taxable income under subtitle A of the Internal Revenue Code of 1954 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2, relating to tax on self-employment income) or prior income, war-profits, or excess-profits tax laws; or

(2) The amount properly allowable as deductions in computing taxable income under subtitle A or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(c) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.*—If no election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939 (see paragraph (d)), the decrease required by paragraph (a) for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws;

(2) The amount properly allowable in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws.

For the purpose of determining the decrease required by this paragraph, it is immaterial whether or not the amount under subparagraph (1) of this paragraph or the amount under subparagraph (2) of this paragraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(d) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where election made.*—If an election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939, the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under such chapter 1 (other than subchapter E, relating to tax on self-employ-

ment income), subchapter E of chapter 2 of the Internal Revenue Code of 1939, or prior income, war-profits, or excess-profit tax laws;

(2) The amount properly allowable as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(e) *Determination of amount allowed which reduced taxpayer's taxes.*—(1) As indicated in paragraphs (b) and (d) of this section, there are situations in which it is necessary to determine (for the purpose of ascertaining the basis adjustment required by paragraph (a) of this section) the extent to which the amount allowed as deductions resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Internal Revenue Code of 1954, or prior income, war-profits, or excess-profits tax laws. This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the "tax-benefit amount allowed." For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount properly allowable as a deduction. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount of the tax-benefit amount allowed.

(2) For the purpose of determining the tax-benefit amount allowed the tax previously determined shall be determined under the principles of section 1314. The only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carryover or carryback of a net operating loss from the taxable year for which the deduction was allowed, and taxable years for which a computation under section 111 or section 1333 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 1311, or section 3801 of the Internal Revenue Code

of 1939, and for any previous application of section 1016(a)(2)(B), or section 113(b)(1)(B)(ii) of the Internal Revenue Code of 1939.

(3) If a determination under section 1016(a)(2)(B) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(4) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(5) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction of erroneous depreciation for certain taxable years, but may not have available adequate records with respect to the deduction of excessive depreciation for other taxable years during which the property was held by its transferor. In such case the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(f) *Determination of amount allowable in prior taxable years.*—

(1) One of the factors in determining the adjustment to basis as of any date is the amount of depreciation, depletion, etc., allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining the adjusted basis of the property for the purpose of determining the amount allowable. Provisions corresponding to the rules in section 1016(a)(2)(B) described in paragraphs (d) and (e) of this section, which limit adjustments to the "tax-benefit amount allowed" where an election is properly exercised, were first enacted by Public Law 539 (82d Congress) approved July 14, 1952. That law provided that corresponding rules are deemed to be includible in all revenue laws applicable to taxable years ending after December 31, 1931. Accordingly, those rules shall be taken into account in determining the amount of depreciation, etc., allowable for any taxable year ending after December 31, 1931. For example, if the adjusted basis of property held by the taxpayer since January 1, 1930, is determined as of January 1, 1955, and if an election was properly made under section 1020, or section 113(d) of the

1939 Code, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1955, shall be determined by taking those rules into account for all taxable years ending after December 31, 1931. Public Law 539 made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. If there was a final decision of a court prior to the enactment of Public Law 539, determining the amount allowable for a particular taxable year, such determination shall be adjusted. In such case the adjustment shall be made only for the purpose of taking the provision of that law into account and only to the extent made necessary by such provisions.

(2) Although Public Law 539 amended the law applicable to all taxable years ending after December 31, 1931, the amendment does not permit refund, credit, or assessment of a deficiency for any taxable year for which such refund, credit, or assessment was barred by any law or rule of law.

(g) *Property with transferred basis.*—The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 1016(b), or section 113(b) (2) of the Internal Revenue Code of 1939, with respect to the period the property was held by the transferor, donor, or grantor:

(1) An election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, by a transferor, donor, or grantor, which is made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. An election or a revocation of an election made before the date of the transfer, gift, or grant of the property shall be taken into account in determining under section 1016(b) the adjustments to basis of such property as of the date of the transfer, gift, or grant, whether or not an election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, was made by the transferee, donee, or grantee.

(2) An election by the transferee, donee, or grantee, or a revocation of such an election shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election or a revocation of an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which the election or revocation was made.

(h) *Examples.*—The application of section 1016(a) (1) and (2) may be illustrated by the following examples:

*Example (1).* The case of Corporation A discloses the following facts:

(1)	(2)	(3)	(4)	(5)	(6)
Year	Amount allowed	Amount allowed which re- duced tax- payer's taxes	Amount allowable	Amount allowable but not less than amount allowed	Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949-----	\$6,000	\$5,500	\$5,000	\$6,000	\$5,500
1950-----	7,000	7,000	6,500	7,000	7,000
1951-----	5,000	4,000	6,500	6,500	6,500
Total, 1949-51-----				\$19,500	\$19,000
1952-----	6,500	6,500	6,000		\$6,500
1953-----	5,000	4,000	4,000		4,000
1954-----	4,500	4,500	6,000		6,000
Total, 1952-54-----					\$16,500

The cost or other basis is to be adjusted by \$16,500 with respect to the years 1952-1954, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949-1951, the amount of such adjustment depending upon whether an election was properly made under section 1020, or section 113 (d) of the Internal Revenue Code of 1939. If no such election was made, the amount of the adjustment with respect to the years 1949-1951 is \$19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949-1951 is \$19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

*Example (2).* Corporation A, which files its returns on the basis of a calendar year, purchased a building on January 1, 1950, at a cost of \$100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of \$4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 1020, or section 113 (d) of the Internal Revenue Code of 1939. No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is \$88,166, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		\$100,000	50	\$2,000	\$4,000
1951	\$4,000	96,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,917	90,083	47	1,917	4,000
1954	11,834	88,166			

*Example (3).* The facts are the same as in example (2), except that Corporation A made a proper election under section 1020. In such case, the adjusted basis of the building as of January 1, 1954, is \$92,000 computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		\$100,000	50	\$2,000	\$4,000
1951	\$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

*Example (4).* If it is assumed that in example (2), or in example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire \$4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be \$86,083 in example (2), and \$90,000 in example (3).

*Example (5).* The facts are the same as in example (2) except that for the year 1950 all of the \$4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in example (2).

*Example (6).* The facts are the same as in example (3) except that for the year 1950 all of the \$4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is \$90,123, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950-----		\$100,000	50	\$2,000	\$4,000
1951-----	\$4,000	96,000	49	1,959	4,000
1952-----	5,959	94,041	48	1,959	4,000
1953-----	7,918	92,082	47	1,959	4,000
1954-----	9,877	90,123	-----	-----	-----

§ 1.1016-4 EXHAUSTION, WEAR AND TEAR, OBSOLESCENCE, AMORTIZATION, AND DEPLETION; PERIODS DURING WHICH INCOME WAS NOT SUBJECT TO TAX.—Adjustments to basis must be made for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent actually sustained in respect of:

(a) Any period before March 1, 1913, and

(b) Any period since February 28, 1913, during which the property was held by a person or an organization not subject to income taxation under chapter 1 of the Internal Revenue Code of 1954 or prior income tax laws.

The amount of the afordescribed deductions actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable. Otherwise the amount actually sustained will be the amount that would have been allowed as a deduction had the taxpayer been subject to income tax during such period. In the case of depreciation, such deduction will be determined by using the straight line method.

§ 1.1016-5 MISCELLANEOUS ADJUSTMENTS TO BASIS.—(a) *Certain stock distributions*.—(1) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921). For adjustments to basis in the case of certain corporate distributions, see section 301 and the regulations thereunder.

(2) The application of subparagraph (1) may be illustrated by the following example:

*Example.* A, who makes his returns upon the calendar year basis, purchased stock in 1923 for \$5,000. He received in 1924 a distribution of \$2,000 paid out of earnings and profits of the corporation accumulated before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1954 is \$5,000 less \$2,000, or \$3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between \$3,000 and the amount realized from the sale or other disposition.

(b) *Amortizable bond premium*.—In the case of a tax-exempt



bond, basis shall be reduced by the amount of the amortizable bond premium disallowable as a deduction under section 171(a)(2), or under section 125(a)(2) of the Internal Revenue Code of 1939 and, in the case of any other bond (as defined in section 171(d)), basis shall be reduced by the amount of the deductions allowable under section 171(a)(1), or under section 125(a)(1) of the Internal Revenue Code of 1939.

(c) *Short-term municipal bonds.*—In the case of a short-term municipal bond (as defined in section 75(b)), basis shall be adjusted to the extent provided in section 75 or as provided in section 22(o) of the Internal Revenue Code of 1939, and the regulations thereunder.

(d) *Sale or exchange of residence.*—Where the acquisition of a new residence results in the nonrecognition of any part of the gain on the sale, exchange, or involuntary conversion of the old residence, the basis of the new residence shall be reduced by the amount of the gain not so recognized pursuant to section 1034(a), or section 112(n) of the Internal Revenue Code of 1939, and regulations thereunder. See section 1034(e) and regulations thereunder.

(e) *Loans from Commodity Credit Corporation.*—In the case of property pledged to the Commodity Credit Corporation, the basis of such property shall be increased by the amount received as a loan from such corporation and treated by the taxpayer as income for the year in which received under section 77, or under section 123 of the Internal Revenue Code of 1939. The basis of such property shall be reduced to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(f) *Deferred development and exploration expenses.*—Expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under sections 615 and 616, or under the corresponding provisions of prior income tax laws, are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Internal Revenue Code of 1954, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016-3. For example, if a taxpayer purchases unexplored and undeveloped mining property for \$1,000,000 and at the close of the development stage has incurred exploration and development costs of \$9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be \$10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of \$2,000,000 and has deducted allowable deferred exploration and development expenditures of \$2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss from a sale will be \$6,000,000.

(g) *Sale of land with unharvested crop.*—In the case of an un-  
§ 1.1016-5(c)

harvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231, the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 268, as deductions in computing taxable income. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provisions of section 1016 or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing \$100 and \$50 depreciation on a tractor used only to cultivate such crop, and such items are disallowed under section 268, the adjustments to the basis of such crop shall include an increase of \$150 for such items and the adjustments to the basis of the tractor shall include a reduction of \$50 for depreciation.

(h) *Consent dividends*.—(1) In the case of amounts specified in a shareholder's consent to which section 28 of the Internal Revenue Code of 1939 applies, the basis of the consent stock shall be increased to the extent provided in subsection (h) of such section.

(2) In the case of amounts specified in a shareholder's consent to be treated as a consent dividend to which section 565 applies, the basis of the consent stock shall be increased by the amount which, under section 565(c) (2), is treated as contributed to the capital of the corporation.

(i) *Stock in foreign personal holding company*.—In the case of the stock of a United States shareholder in a foreign personal holding company, basis shall be adjusted to the extent provided in section 551 (f) or corresponding provisions of prior income tax laws.

(j) *Research and experimental expenditures*.—Research and experimental expenditures treated as deferred expenses under section 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Internal Revenue Code of 1954, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016-3.

(k) *Deductions disallowed in connection with disposal of coal*.—Basis shall be adjusted by the amount of the deductions disallowed under section 272 with respect to the disposal of coal covered by section 631.

(l) *Expenditures attributable to grants or loans covered by section 621*.—In the case of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, basis shall be adjusted to the extent provided in section 621, or in section 22(b) (15) of the Internal Revenue Code of 1939.

§ 1.1016-6 OTHER APPLICABLE RULES.—(a) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(b) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Internal Revenue Code of 1954, and prior internal revenue laws.

§ 1.1016-7 ADJUSTED BASIS; CANCELLATION OF INDEBTEDNESS UNDER BANKRUPTCY ACT.—(a) In addition to the adjustments provided in section 1016, further adjustment is required in the case of a cancellation or reduction of indebtedness in any proceeding under chapters X, XI, or XII of the Bankruptcy Act (11 U. S. C. c. 10, 11, and 12) and under sections 12, 74, or 77B of the Bankruptcy Act of 1898 as amended. For exceptions to the above rule see sections 372, 373, 374, and 1018. Furthermore, no such further adjustment will be made in the case of a "wage earner" as the term is defined in section 606(8) of the Bankruptcy Act (11 U. S. C. 1006(8)). The further adjustments required by this section shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable) whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by such subparagraphs) as follows: the cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under subparagraphs (1) and (2) of this paragraph) of each such unit of property bears to the sum of the adjusted bases (after adjustment under such subparagraphs) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments

made under subparagraphs (1), (2), and (3), of this paragraph shall next be applied to reduce the cost or other basis of any units of property covered by such subparagraphs which have a remaining basis (after adjustment under such subparagraphs) greater than their fair market value, as follows: the cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining bases of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by subparagraphs (1), (2), and (3) of this paragraph is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(5) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable as follows: the cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable. The process shall be repeated until the adjusted bases of inventory, notes receivable, and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

(b) For the purposes of this section:

(1) Basis shall be determined as of the dates of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced;

(2) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(3) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(4) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(5) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced.

(c) Any determination of value in a proceeding under the Bank-

ruptcy Act (11 U. S. C. 1 et seq.), shall not constitute a determination of fair market value for the purpose of this section.

(d) The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this section.

§ 1.1016-8 ADJUSTED BASIS; CANCELLATION OF INDEBTEDNESS; SPECIAL CASES.—If the taxpayer and the Commissioner of Internal Revenue agree, the basis of the taxpayer's property may be adjusted in a manner different from that set forth in § 1.1016-7. Variation from such rule may, for example, involve adjusting the basis of any part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation. Agreement between the taxpayer and the Commissioner of Internal Revenue as to any variation from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

§ 1.1016-9 ADJUSTED BASIS; MUTUAL SAVINGS BANKS, BUILDING AND LOAN ASSOCIATIONS, AND COOPERATIVE BANKS.—(a) The adjustments to the cost or other basis of property provided in section 1016 and §§ 1.1016-1 to 1.1016-8, inclusive, are applicable in the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, although such institutions were exempt from tax for taxable years beginning before January 1, 1952. Proper adjustment must be made under section 1016 for the entire period since the acquisition of property. Thus, adjustment to basis must be made for depreciation sustained for all prior taxable years although such institution may have been exempt from tax during such years. Similarly, in the case of tax-exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond (or in the case of bonds not issued with interest coupons or in registered form, from the date such bonds are subject to amortization under section 171).

(b) The application of paragraph (a) of this section may be illustrated by the following example:

*Example.* On January 1, 1954, Z, a mutual savings bank, which keeps its books on a calendar year basis, owns a tax-exempt \$1,000 noncallable bond maturing on January 1, 1964. Such bond was acquired by Z on January 1, 1934, for \$1,300. It was sold by Z on December 31, 1954, for \$1,250. The yearly rate of amortization of the premium, determined by dividing the total premium of \$300 by the life of the bond (30 years) is \$10. Z realizes a gain of \$80 from such sale computed as follows:

(1) Cost of bond .....	\$1,300
(2) Amount of bond premium attributable to years 1942 through 1951, during which Z was exempt from tax (\$10 times 10 years) .....	\$100
(3) Amount of bond premium amortized from January 1, 1952, through December 31, 1954 (\$10 times 3 years) .....	30

(4) Total amount of adjustments to basis (aggregate of (2) and (3)) .....	130
(5) Adjusted basis of bond at close of 1954 (1) reduced by (4).....	\$1,170
(6) Gain realized upon sale—excess of sale price over adjusted basis (\$1,250 minus \$1,170) .....	80

The basis of a fully taxable bond purchased at a premium shall be adjusted from the date to which the election applies to amortize such premium in accordance with the provisions of section 171, except that no adjustments shall be allowable for such portion of the premium attributable to the period prior to the election.

(c) In the case of a mortgage (not within the definition of section 171(d)) purchased, acquired, or originated at a premium, where the principal of such mortgage is payable in installments, adjustments to the basis of the premium must be made for all taxable years (whether or not the institution was exempt from tax during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such institution. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest. For the method of amortization in the case of corporate mortgages purchased, acquired or originated at a premium see § 1.171-2(e) of the regulations under section 171.

§ 1.1016-10 SUBSTITUTED BASIS.—(a) Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b), the adjustments indicated in §§ 1.1016-1 to 1.1016-6, inclusive, shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b)(1), the adjustments indicated in §§ 1.1016-7 to 1.1016-9, inclusive, and in section 1017 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

(b) The application of this section may be illustrated by the following example:

*Example.* A, who makes his returns upon the calendar year basis, in 1935 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the

amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 1.1018 STATUTORY PROVISIONS; ADJUSTMENT OF CAPITAL STRUCTURE BEFORE SEPTEMBER 22, 1938.

SEC. 1018. ADJUSTMENT OF CAPITAL STRUCTURE BEFORE SEPTEMBER 22, 1938.

Where a plan of reorganization of a corporation, approved by the court in a proceeding under section 77B of the National Bankruptcy Act, as amended (48 Stat. 912), is consummated by adjustment of the capital or debt structure of such corporation without the transfer of its assets to another corporation, and a final judgment or decree in such proceeding has been entered before September 22, 1938, then the provisions of section 270 of the Bankruptcy Act, as amended (54 Stat. 709; 11 U. S. C. 670), shall not apply in respect of the property of such corporation. For the purposes of this section, the term "reorganization" shall not be limited by the definition of such term in section 112(g) of the Internal Revenue Code of 1939.

§ 1.1018-1 ADJUSTED BASIS; EXCEPTION TO SECTION 270 OF THE BANKRUPTCY ACT, AS AMENDED.—The adjustment to basis provided by section 270 of the Bankruptcy Act, as amended (11 U. S. C. 670), and by §§ 1.1016-7 and 1.1016-8 shall not be made if, in a proceeding under section 77B of such Act, as amended (11 U. S. C. 207; 48 Stat. 912), indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered before September 22, 1938. Section 1018 and this section do not apply if the plan of reorganization under such section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

§ 1.1019 STATUTORY PROVISIONS; PROPERTY ON WHICH LESSEE HAS MADE IMPROVEMENTS.

SEC. 1019. PROPERTY ON WHICH LESSEE HAS MADE IMPROVEMENTS.

Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 109 (relating to improvements by lessee on lessor's property). If an amount representing any part of the value of the real property attributable to buildings erected or other improvements made by a lessee in respect of such property was included in gross income of the lessor for any taxable year beginning before January 1, 1942, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income.

§ 1.1019-1 PROPERTY ON WHICH LESSEE HAS MADE IMPROVEMENTS.—In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any

taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of \$50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of \$22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth \$75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (sections 1201-1241, inclusive).

#### § 1.1022 STATUTORY PROVISIONS; CROSS REFERENCES.

##### SEC. 1022. CROSS REFERENCES.

(1) For certain distributions by a corporation which are applied in reduction of basis of stock, see section 301(c) (2).

(2) For basis of property in case of certain reorganizations and arrangements under the Bankruptcy Act, see sections 270, 396, and 522 of that Act, as amended (11 U. S. C. 670, 796, 922).

(3) For basis in case of construction of new vessels, see section 511 of the Merchant Marine Act, 1936, as amended (46 U. S. C. 1161).

(4) For rules applicable in case of payments in violation of Defense Production Act of 1950, as amended, see section 405 of that Act.

#### COMMON NONTAXABLE EXCHANGES

#### § 1.1033(a) STATUTORY PROVISIONS; COMMON NONTAXABLE EXCHANGES; INVOLUNTARY CONVERSIONS; GENERAL RULE.

##### SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED PRIOR TO 1951.—Into money, and the disposition of the converted property occurred before January 1, 1951, no gain shall be recognized if such money is forthwith in good faith, under regulations prescribed by the Secretary or his delegate, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain shall be recognized to the extent of the money which is not so expended (regardless of whether such money is



received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain). For purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(3) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED AFTER 1950.—Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) NONRECOGNITION OF GAIN.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. For purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (c) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012.

(B) PERIOD WITHIN WHICH PROPERTY MUST BE REPLACED.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

(C) TIME FOR ASSESSMENT OF DEFICIENCY ATTRIBUTABLE TO GAIN UPON CONVERSION.—If a taxpayer has made the election provided in subparagraph (A), then—

(i) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212 (c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) TIME FOR ASSESSMENT OF OTHER DEFICIENCIES ATTRIBUTABLE TO ELECTION.—If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased before the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such

last taxable year may be assessed (notwithstanding the provisions of section 6212 (c) or 6501 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

§ 1.1033(a)-1 INVOLUNTARY CONVERSIONS; NONRECOGNITION OF GAIN.—(a) *In general*.—Section 1033 applies to cases where property is compulsorily or involuntarily converted. An “involuntary conversion” may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An “involuntary conversion” may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Different rules for reinvestment apply, depending upon whether the disposition of the converted property occurred after 1950 or before 1951 (see §§ 1.1033(a)-2, 1.1033(a)-3, and 1.1033(a)-4. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules*.—For rules relating to basis of property acquired through involuntary conversions, see § 1.1033(c)-1. Special rules apply to involuntary conversions of residence property, property sold pursuant to reclamation laws, and livestock destroyed by disease (see §§ 1.1033(b)-1, 1.1033(d)-1, and 1.1033(e)-1, respectively). For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332 (b) (3) and regulations issued thereunder.

§ 1.1033(a)-2 INVOLUNTARY CONVERSION WHERE DISPOSITION OF THE CONVERTED PROPERTY OCCURRED AFTER DECEMBER 31, 1950.—

(a) *In general*.—This section applies only with respect to involuntary conversions where the disposition of the converted property occurred after December 31, 1950, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies. The term “disposition of the converted property” means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.*—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.*—(1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033 the term “control” means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(3), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an “amended return”. If a decision is made to make an election under section 1033(a)(3) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced,

a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of the one year after the close of the first taxable year in which any part of the gain from the conversion is realized, and shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(c), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 1033(c), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a) (3), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for

replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(3) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(3), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the "amount realized" upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth \$100,000 subject to a \$50,000 mortgage (re-

gardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer \$60,000 and awards the mortgagee \$50,000 in satisfaction of the mortgage, the entire \$110,000 is considered to be the "amount realized" by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

§ 1.1033(a)-3 INVOLUNTARY CONVERSION WHERE DISPOSITION OF THE CONVERTED PROPERTY OCCURRED BEFORE JANUARY 1, 1951.—(a) This section applies only with respect to involuntary conversions where the disposition of the converted property occurred before January 1, 1951, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies. The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) (1) Upon the involuntary conversion of property described in section 1033, no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 1033(a)(2), the gain, if any, is recognized to the extent of the money which is not so expended. For example, a vessel purchased by A in 1949 for \$100,000 is destroyed by a typhoon in 1950, and A receives in 1954 insurance in the amount of \$100,000. This money is not expended in the manner provided in section 1033(a)(2), but there is no gain since the insurance does not exceed the basis (disregarding, for the purposes of this example, the adjustment for depreciation). In 1955, A receives insurance from a second policy of \$200,000 on account of the destruction of the vessel. He expends this amount in the manner provided in section 1033(a)(2). The gain in 1955 upon the receipt of the \$200,000 is recognized to the extent of \$100,000, the amount of the money received in 1954 which was not expended in the manner provided in section 1033(a)(2).

(2) Losses from involuntary conversions are recognized or not recognized without regard to section 1033. The expenditure in the manner provided in section 1033(a)(2) of money received upon an involuntary conversion is not necessary for the transaction to be considered completed for the purpose of determining such loss.

(c) In order to avail himself of the benefits of section 1033(a)(2) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 1033(a)(2) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use,

notwithstanding the fact that there was no other such property available for purchase.

(d) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as part of the "money" into which the property is converted, regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth \$100,000 subject to a \$50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer \$60,000 and awards the mortgagee \$50,000 in satisfaction of the mortgage, the entire \$110,000 is considered to be the "money" into which the property was converted. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(e) The provisions of section 1033(a)(2) are applicable to property used for residential or farming purposes.

(f) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(g) There is no investment in property similar in character and devoted to a similar use if—

(1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(3) The owner of a requisitioned tug uses the proceeds to buy barges.

(h) It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

[Section 1.1033(a)-4 is substantially the same as § 29.112(f)-1 of Regulations 111.]

§ 1.1033(a)-4 REPLACEMENT FUNDS WHERE DISPOSITION OF THE CONVERTED PROPERTY OCCURRED BEFORE JANUARY 1, 1951.—(a) This section applies only with respect to involuntary conversions where the disposition of the converted property (as defined in § 1.1033(a)-3) occurred before January 1, 1951, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies.

§ 1.1033(a)-3(d)

(b) In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately (for example, because of a shortage of materials or an industry-wide strike), he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application on Form 1114 to the district director for the district in which his return is required to be filed for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the district director may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See 6 U. S. C. 15, (Appendix to the Income Tax Regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his taxable (or net) income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the district director, the applicant, and the surety or depository may each have a copy.

[Section 1.1033(a)-4 is substantially the same as § 29.112(f)-2 of Regulations 111.]

## § 1.1033(b) STATUTORY PROVISIONS; INVOLUNTARY CONVERSIONS; RESIDENCE OF TAXPAYER.

### SEC. 1033. INVOLUNTARY CONVERSIONS. \* \* \*

(b) RESIDENCE OF TAXPAYER.—Subsection (a) shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of the residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954.

§ 1.1033(b)-1 INVOLUNTARY CONVERSION OF PRINCIPAL RESIDENCE.—Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. Section 1033 shall not apply in the case of an involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property disposed of after December 31, 1950, and before January 1, 1954, which is used by the taxpayer partially as a princi-



pal residence and partially for other purposes, proper allocation shall be made and § 1.1033(a)-2 and § 1.1033(c)-1 shall apply only with respect to the involuntary conversion of the portion used for such other purposes.

§ 1.1033(c) STATUTORY PROVISIONS; INVOLUNTARY CONVERSIONS; BASIS OF PROPERTY ACQUIRED THROUGH INVOLUNTARY CONVERSION.

SEC. 1033. INVOLUNTARY CONVERSIONS. \* \* \*

(c) BASIS OF PROPERTY ACQUIRED THROUGH INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in subsection (a) (1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. This subsection shall not apply in respect of property acquired as a result of a compulsory or involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property purchased by the taxpayer in a transaction described in subsection (a) (3) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

§ 1.1033(c)-1 BASIS OF PROPERTY ACQUIRED AS A RESULT OF AN INVOLUNTARY CONVERSION.—(a) The provisions of the first sentence of section 1033(c) may be illustrated by the following example:

*Example.* A's vessel which has an adjusted basis of \$100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of \$200,000. If A invests \$150,000 in a new vessel, taxable gain to the extent of \$50,000 would be recognized. The basis of the new vessel is \$100,000; that is, the adjusted basis of the old vessel (\$100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel (\$50,000) plus the amount of gain recognized upon the conversion (\$50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(c) may be illustrated by the following example:

*Example.* A taxpayer realizes \$22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was \$10,000, and he spent in the same year \$20,000 for a new barn which resulted in the nonrecognition of \$10,000 of the \$12,000 gain on the conversion. The basis of the new barn to the taxpayer would be \$10,000—the cost of the new barn (\$20,000) less the amount of the gain not recognized on the conversion (\$10,000). The basis of the new barn would not be a substituted basis in the hands of the

taxpayer within the meaning of section 1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost \$8,000 and \$12,000, respectively, then the basis of the two barns would be \$4,000 and \$6,000, respectively, the total basis of the purchased property (\$10,000) allocated in proportion to their respective costs (\$8,000/20,000 of \$10,000, or \$4,000; and 12,000/20,000 of \$10,000, or \$6,000).

§ 1.1033(d) STATUTORY PROVISIONS; INVOLUNTARY CONVERSIONS; PROPERTY SOLD PURSUANT TO RECLAMATION LAWS.

SEC. 1033. INVOLUNTARY CONVERSIONS. \* \* \*

(d) PROPERTY SOLD PURSUANT TO RECLAMATION LAWS.—For purposes of this subtitle, if property lying within an irrigation project is sold or otherwise disposed of in order to conform to the acreage limitation provisions of Federal reclamation laws, such sale or disposition shall be treated as an involuntary conversion to which this section applies.

§ 1.1033(d)-1 DISPOSITION OF EXCESS PROPERTY WITHIN IRRIGATION PROJECT DEEMED TO BE INVOLUNTARY CONVERSION.—(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term “excess lands” means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033(d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of § 1.1033(a)-2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under § 1.1033(a)-2(c)(2) shall include the authority whereby the lands disposed of are considered “excess lands”, as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term “involuntary conversion”, where it appears in subtitle A or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e. g., section 1231 and the regulations thereunder.)

§ 1.1033(e) STATUTORY PROVISIONS; INVOLUNTARY CONVERSIONS;  
LIVESTOCK DESTROYED BY DISEASE.

SEC. 1033. INVOLUNTARY CONVERSIONS. \* \* \*

(e) LIVESTOCK DESTROYED BY DISEASE.—For purposes of this subtitle, if livestock are destroyed by or on account of disease, or are sold or exchanged because of disease, such destruction or such sale or exchange shall be treated as an involuntary conversion to which this section applies.

§ 1.1033(e)-1 DESTRUCTION OR DISPOSITION OF LIVESTOCK BECAUSE OF DISEASE.—(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of § 1.1033(a)-2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under § 1.1033(a)-2(c) (2) shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term "involuntary conversion", where it appears in subtitle A or the regulations thereunder, includes disposition of livestock described in this section. (See, e. g., section 1231 and the regulations thereunder.)

§ 1.1033(f) STATUTORY PROVISIONS; INVOLUNTARY CONVERSIONS;  
CROSS REFERENCES.

SEC. 1033. INVOLUNTARY CONVERSIONS. \* \* \*

(f) CROSS REFERENCES.

(1) For determination of the period for which the taxpayer has held property involuntarily converted, see section 1223.

(2) For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a).

§ 1.1033(f)-1 EFFECTIVE DATE.—The provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the date of enactment of the Internal Revenue Code of 1954. See section 7551(a) (1) (A).

CAPITAL GAINS AND LOSSES  
TREATMENT OF CAPITAL GAINS

§ 1.1201 STATUTORY PROVISIONS; ALTERNATIVE TAX.

SEC. 1201. ALTERNATIVE TAX.

(a) CORPORATIONS.—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in

§ 1.1033(e)

lieu of the tax imposed by sections 11, 511, 802(a), 821(a)(1) or (b), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this section had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) **OTHER TAXPAYERS.**—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

[Sec. 1201(a) as amended by sec. 5 of the Life Insurance Company Tax Act for 1955 (70 Stat. 36), effective for taxable years beginning after December 31, 1954. For taxable years beginning before January 1, 1955, sec. 1201(a) did not provide that the alternative tax would be in lieu of the tax imposed by sec. 802(a).]

§ 1.1201-1 **ALTERNATIVE TAX.**—(a) *Corporations.*—In case the net long-term capital gain of any corporation exceeds the net short-term capital loss, section 1201(a) imposes an alternative tax in lieu of the tax imposed by section 11, 511, 821(a)(1) or (b), and 831(a), if and only if such alternative tax is less than the tax imposed by such sections. For taxable years beginning after December 31, 1954, the alternative tax shall also be in lieu of the tax imposed by section 802(a) if such alternative tax is less than the tax imposed by such section. The alternative tax is not in lieu of the personal holding company tax imposed by section 541, or of any other tax not specifically set forth in section 1201(a). The alternative tax is the sum of—(1) a partial tax computed at the rates provided by sections 11, 511, 802(a) (for taxable years beginning after December 31, 1954), 821(a)(1) or (b), and 831(a) on the taxable income of the taxpayer decreased by the amount of the excess of the net long-term capital gain over the net short-term capital loss, and (2) an amount equal to 25 percent of such excess or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess. In the computation of the partial tax the special deductions provided for in sections 243, 244, 245, 247, 922, and 941 shall not be recomputed as the result of the reduction of taxable income by the excess of net long-term capital gain over net short-term capital loss.

(b) *Other taxpayers.*—In case the net long-term capital gain of a taxpayer (other than a corporation) exceeds the net short-term capital loss, section 1201(b) imposes an alternative tax in lieu of the tax imposed by sections 1 and 511, if and only if such alternative tax is less than the tax imposed by sections 1 and 511. The alternative tax is not in lieu of any other tax not specifically set forth in section 1201(b). The alternative tax is the sum of—

§ 1.1201-1(b)

(1) A partial tax, computed at the rates provided by sections 1 and 511 on the taxable income reduced by an amount equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss, plus

(2) 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

See § 1.1-3 for rule relating to the computation of the limitation on tax under section 1(c) in cases where the alternative tax is imposed. See § 1.34-2(a) for rule relating to the computation of the dividend received credit under section 34 and § 1.35-1(a) for rule relating to the computation of credit for partially tax-exempt interest under section 35 in cases where the alternative tax is imposed.

(c) *Tax-exempt trusts and organizations.*—In applying section 1201 in the case of tax-exempt trusts or organizations subject to the tax imposed by section 511, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business taxable income under section 512. Under section 512, the only amount taken into account as capital gain or loss is that resulting from the application of section 631(a), relating to the election to treat the cutting of timber as a sale or exchange.

(d) *Joint returns.*—In the case of a joint return, the excess of any net long-term capital gain over any net short-term capital loss is to be determined by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

(e) *Application of section.*—The following example illustrates the application of the provisions of section 1201 and of this section in the case of an individual taxpayer:

*Example.* A, a single individual, has for the calendar year 1954 taxable income (exclusive of capital gains and losses) of \$99,400. He realizes in 1954 a gain of \$50,000 on the sale of a capital asset held for 19 months and sustains a loss of \$20,000 on the sale of a capital asset held for five months. He has no other capital gains or losses. Since the alternative tax is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is, \$74,298. The tax is computed as follows:

TAX UNDER SECTION 1	
Taxable income exclusive of capital gains and losses.....	\$99,400
Net long-term capital gain (100 percent of \$50,000).....	\$50,000
Net short-term capital loss (100 percent of \$20,000).....	20,000
Excess of net long-term capital gain over the net short-term capital loss .....	30,000
Deduction of 50 percent of excess of net long-term capital gain over the net short-term capital loss (section 1202) .....	\$129,400
	15,000
Taxable income .....	\$114,400
Tax under section 1 .....	\$80,136

## ALTERNATIVE TAX UNDER SECTION 1201(b)

Taxable income .....	\$114,400
Less 50 percent of excess of net long-term capital gain over net short-term capital loss (section 1201(b) (1) ) .....	15,000
Taxable income exclusive of capital gains and losses.....	\$99,400
Partial tax (tax on \$99,400) .....	\$66,798
Plus 25 percent of \$30,000 .....	7,500
Alternative tax under section 1201(b) .....	\$74,298

## § 1.1202 STATUTORY PROVISIONS; DEDUCTION FOR CAPITAL GAINS.

### SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gains exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains from the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

§ 1.1202-1 DEDUCTION FOR CAPITAL GAINS.—(a) In computing gross income, adjusted gross income, taxable income, net capital gain, and net capital loss, 100 percent of any gain or loss (computed under section 1001, recognized under section 1002, and taken into account without regard to sections 1201-1241, inclusive,) upon the sale or exchange of a capital asset shall be taken into account regardless of the period for which the capital asset has been held. Nevertheless, the net short-term capital gain or loss and the net long-term capital gain or loss must be separately computed. In computing the adjusted gross income or the taxable income of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of the excess is allowable as a deduction from gross income under section 1202.

(b) For the purpose of computing the deduction allowable under section 1202 in the case of an estate or trust, any long-term or short-term capital gains which, under sections 652 and 662, are includible in the gross income of its income beneficiaries as gains derived from the sale or exchange of capital assets must be excluded in determining whether, for the taxable year of the estate or trust, its net long-term capital gain exceeds its net short-term capital loss. To determine the extent to which such gains are includible in the gross income of a beneficiary, see the regulations under sections 652 and 662. For example, during 1954 a trust realized a gain of \$1,000 upon the sale of stock held for 10 months. Under the terms of the trust instrument of all such gains must be distributed during the taxable year to A, the sole income beneficiary. Assuming that under section 652 or 662 A must include all of such gain in his gross income, the trust is not entitled to any deduction with respect to such gain under section 1202. Assuming A had no other capital gains or losses for 1954, he would be entitled to a deduction of \$500 under section 1202.

For purposes of this section, an income beneficiary shall be any beneficiary to whom an amount is required to be distributed, or is paid or credited, which is includible in his gross income.

(c) The provisions of this section may be illustrated by the following example:

*Example.* A, an individual, had the following transactions in 1954:

Long-term capital gain .....	\$6,000	
Long-term capital loss .....	4,000	
Net long-term capital gain .....		\$2,000
Short-term capital loss .....	\$1,800	
Short-term capital gain .....	300	
Net short-term capital loss .....		1,500
Excess of net long-term capital gain over net short-term capital loss .....		\$500

Since the net long-term capital gain exceeds the net short-term capital loss by \$500, 50 percent of the excess, or \$250, is allowable as a deduction under section 1202.

#### TREATMENT OF CAPITAL LOSSES

### § 1.1211 STATUTORY PROVISIONS; LIMITATION ON CAPITAL LOSSES.

#### SEC. 1211. LIMITATION ON CAPITAL LOSSES.

(a) **CORPORATIONS.**—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

(b) **OTHER TAXPAYERS.**—In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or \$1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, "taxable income" as used in this subsection shall be read as "adjusted gross income".

§ 1.1211-1 **LIMITATION ON CAPITAL LOSSES.**—(a) Section 1211 (a) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of the gains from such sales or exchanges, and section 1211 (b) provides that, in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or \$1,000, whichever is smaller. For purposes of section 1211 (b), taxable income is to be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. For example, the deductions available to estates and trusts under section 642(b) are in lieu of the deductions allowed under section 151, and, in the case of estates and

trusts, are to be added back to taxable income for the purposes of section 1211(b).

(b) The provisions of section 1211(b) may be illustrated by the following examples:

*Example (1).* A, an individual with one exemption allowable as a deduction under section 151, has the following transactions in 1954:

Taxable income exclusive of capital gains and losses.....	\$4,400
Deductions provided in section 151.....	600
	<hr/>
Taxable income for purposes of section 1211(b).....	\$5,000
	<hr/>
Long-term capital gain .....	\$1,000
Long-term capital loss .....	5,300
	<hr/>
Net long-term capital loss .....	\$4,300
Amount deductible under section 1211(b) .....	\$1,000

*Example (2).* B, an individual with one exemption allowable as a deduction under section 151, has the following transactions in 1954:

Taxable income exclusive of capital gains and losses.....	\$90
Deductions provided in section 151 .....	600
	<hr/>
Taxable income for purposes of section 1211(b).....	\$690
Long-term capital gain .....	\$1,000
Long-term capital loss .....	5,200
	<hr/>
Net long-term capital loss .....	\$4,200
Amount deductible under section 1211(b).....	\$690

In example (1), the net long-term capital loss of \$4,300 is allowable in 1954 only to the extent of \$1,000 since the latter amount is smaller than the taxable income of \$5,000. The remaining \$3,300 of the net long-term capital loss becomes a net capital loss to be carried over to succeeding years. In example (2), since taxable income for purposes of section 1211(b) is \$690 and since that amount is smaller than the \$4,200 net long-term capital loss and is less than \$1,000, only \$690 of the net long-term capital loss of \$4,200 is allowable in 1954, leaving a net capital loss of \$3,510 to be carried over. For carryover of a net capital loss, see § 1.1212-1.

(c) See section 582(c) for modification of the limitation under section 1211(a) in the case of a bank, as defined in section 581.

(d) In the case of a joint return, the limitation under section 1211(b), relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined taxable income and the combined gains and losses of the spouses.

(e) In case the tax is computed under section 3 (relating to optional tax if adjusted gross income is less than \$5,000) the term "taxable income" as used in section 1211(b) shall be read as "adjusted gross income".



## § 1.1212 STATUTORY PROVISIONS; CAPITAL LOSS CARRYOVER.

## SEC. 1212. CAPITAL LOSS CARRYOVER.

If for any taxable year the taxpayer has a net capital loss, the amount thereof shall be a short-term capital loss in each of the 5 succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this section, a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years, and a net capital loss for a taxable year beginning before October 20, 1951, shall be determined under the applicable law relating to the computation of capital gains and losses in effect before such date.

§ 1.1212-1 NET CAPITAL LOSS CARRYOVER.—(a) Any taxpayer sustaining a net capital loss may, under section 1212, carry over such loss to each of the five succeeding taxable years and treat it in each of such five succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carryover is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the net capital loss carryover may not be included in computing a new net capital loss of a taxable year which can be carried forward to the next five succeeding taxable years. Under section 1212, a net capital loss for taxable year beginning before October 20, 1951, is to be determined under the applicable law relating to the computation of capital gains and losses in effect before such date. Thus, where the applicable law for a taxable year beginning before October 20, 1951, provided that only certain percentages of the gain or loss recognized upon the sale or exchange of a capital asset should be taken into account in computing net capital loss, such percentages are to be taken into account in computing net capital loss for any such taxable year under section 1212. In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for special rules on capital loss carryovers.

(b) The practical operation of the provisions of section 1212 may be illustrated by the following example:

*Example.* (1) For the taxable years 1952 to 1956, inclusive, an individual with one exemption allowable under section 151 (or corresponding provision of prior law) is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and taxable income (net income for 1952 and 1953) as follows:

	1952	1953	1954	1955	1956
Carryover from prior years:					
From 1952 -----		(\$50,000)	(\$29,500)	(\$29,500)	
From 1954 -----				(\$19,500)	(\$13,000)
Net short-term loss (computed without regard to the carryovers)	(\$30,000)	(\$5,000)	(\$10,000)		
Net short-term gain (computed without regard to the carryovers)					
Net long-term loss	(\$20,500)		(\$10,000)	\$40,000 (\$5,000)	
Net long-term gain		\$25,000			\$15,000
Net income or taxable income, computed without regard to capital gains and losses, and, after 1953, without regard to the deduction provided by section 151	\$500	\$500	\$500	\$1,000	\$500
Net capital gain (computed without regard to the carryovers)		\$20,500		\$36,000	
Net capital loss	(\$50,000)		(\$19,500)		
Deduction allowable under sec. 1202 -----			None	None	\$1,000
Taxable income (after deductions allowable under secs. 151 and 1202) -----			None	None	\$900

(2) *Net capital loss of 1952.* The net capital loss is \$50,000. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains (in this case, none) from such sales or such exchanges, and (ii) net income (computed without regard to capital gains and losses) of \$500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain of \$20,500, as defined by section 117(a) (10) (B) of the Internal Revenue Code of 1939, and limited by section 117(e) (1) of the 1939 Code, against which this net capital loss of \$50,000 is allowed in part. The remaining portion—\$29,500—may be carried forward to 1954 and 1955 since there was no net capital gain in 1954. In 1955 this \$29,500 is allowed in full against net capital gain of \$36,000, as defined by section 1222(9) (B) and limited by section 1212.

(3) *Net capital loss of 1954.* The net capital loss is \$19,500. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains (in this case, none) from such sales or exchanges and (ii) taxable income (computed without regard to capital gains and losses and the deductions provided in section 151) of \$500. This amount may be carried forward in full as a short-term loss to 1955. The net capital gain in 1955, before deduction of any carryovers, is \$36,000. The \$29,500 balance of the 1953 loss is first applied against the \$36,000, leaving a balance of \$6,500. Against this amount the \$19,500 loss arising in 1954 is applied, leaving a loss of \$13,000, which may be carried forward to 1956. Since this amount is treated as a short-term capital loss in 1956 under section 1212, the excess of the net long-term capital gain over the net short-term capital loss is \$2,000 (\$15,000 minus \$13,000). Half of this excess is allowable as a deduction under section 1202. Thus, after also de-

ducting the exemption allowed as a deduction under section 151 (\$600) the taxpayer has a taxable income of \$900 for 1956.

(c) (1) The following rules shall be applied in computing net capital loss carryovers by husband and wife:

(i) If a husband and wife making a joint return for any taxable year made separate returns for the preceding year, any net capital loss carryover of each spouse from such preceding taxable year may be carried forward to the taxable year as a short-term capital loss to the extent provided by section 1212.

(ii) If a joint return was made for the preceding taxable year, any net capital loss carryover from such preceding taxable year may be carried forward to the taxable year as a short-term capital loss to the extent provided by section 1212.

(iii) If a husband and wife making separate returns for any taxable year made a joint return for the preceding taxable year, any net capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital losses which gave rise to such net capital loss carryover, and the net capital loss carryover so allocated to each spouse may be carried forward by such spouse to the taxable year as a short-term capital loss to the extent provided in section 1212.

(iv) If separate returns are made both for the taxable year and the preceding taxable year, any net capital loss carryover of each spouse from such preceding taxable year may be carried forward by such spouse to the taxable year as a short-term capital loss to the extent provided in section 1212.

(2) The provisions of subdivisions (i) and (iii) of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* If H and W, husband and wife, make a joint return for 1955, having made separate returns for 1954 in which H had a net capital loss of \$3,000 and W had a net capital loss of \$2,000, in their joint return for 1955 they would have a short-term capital loss of \$5,000 (the sum of their separate net capital loss carryovers from 1954), allowable to the extent provided by section 1212. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was \$5,000 allocable \$3,000 to H and \$2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be \$3,000 and that of W for her separate return would be \$2,000, each allowable to the extent provided by section 1212.

#### GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

#### § 1.1221 STATUTORY PROVISIONS; CAPITAL ASSET DEFINED.

##### SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

§ 1.1221-1 MEANING OF TERMS.—(a) The term “capital assets” includes all classes of property not specifically excluded by section 1221. In determining whether property is a “capital asset”, the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term “capital assets”. Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See § 1.1231-1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term “capital assets” even though depreciation may have been allowed with respect to such property under section 23 (1) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942. However gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of sections 1201-1241, inclusive.

(c) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term “capital assets” if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property. As to the application of section 1231 to the sale or exchange of such property held by such a taxpayer, see § 1.1231-1. For purposes of section 1221(3), the phrase “similar property” includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(d) Section 1221 (4) excludes from the definition of “capital asset” accounts or notes receivable acquired in the ordinary course of trade

or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U. S. C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term "capital assets", gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in sections 1201-1241, inclusive. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 as amended by the Life Insurance Company Tax Act for 1955, and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* A (not a life insurance company) buys a \$100,000, 90-day Treasury bill upon issuance for \$99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for \$99,999.50. The entire net gain to A of \$1.50 may be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to gain. If B holds the bill until maturity his net gain of \$0.50 may similarly be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to loss.

*Example (2).* The facts in this example are the same as in example (1) except that the selling price to B is \$99,998.50. The net gain to A of \$0.50 may be taken into account without allocating \$1 to interest and \$0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of \$1.50 may be taken into account as a single item of income without allocating \$1 to interest and \$0.50 to gain.

# § 1.1222 STATUTORY PROVISIONS; OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

## SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

(1) **SHORT-TERM CAPITAL GAIN.**—The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(2) **SHORT-TERM CAPITAL LOSS.**—The term “short-term capital loss” means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(3) **LONG-TERM CAPITAL GAIN.**—The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(4) **LONG-TERM CAPITAL LOSS.**—The term “long-term capital loss” means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(5) **NET SHORT-TERM CAPITAL GAIN.**—The term “net short-term capital gain” means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

(6) **NET SHORT-TERM CAPITAL LOSS.**—The term “net short-term capital loss” means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

(7) **NET LONG-TERM CAPITAL GAIN.**—The term “net long-term capital gain” means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

(8) **NET LONG-TERM CAPITAL LOSS.**—The term “net long-term capital loss” means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(9) **NET CAPITAL GAIN.**—

(A) **CORPORATIONS.**—In the case of a corporation, the term “net capital gain” means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

(B) **OTHER TAXPAYERS.**—In the case of a taxpayer other than a corporation, the term “net capital gain” means the excess of—

(i) the sum of the gains from sales or exchanges of capital assets, plus taxable income (computed without regard to the deductions provided by section 151, relating to personal exemptions or any deduction in lieu thereof) of the taxpayer or \$1,000, whichever is smaller, over

(ii) the losses from such sales or exchanges.

For purposes of this subparagraph, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the taxpayer elects to pay the optional tax under section 3, the term “taxable income” as used in this subparagraph shall be read as “adjusted gross income.”

(10) **NET CAPITAL LOSS.**—The term “net capital loss” means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under section 1212 shall be excluded.

§ 1.1222-1 OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.  
—(a) The phrase “short-term” applies to the category of gains and losses arising from the sale or exchange of capital assets held for six months or less; the phrase “long-term” to the category of gains and losses arising from the sale or exchange of capital assets held for more than six months. The fact that some part of a loss from

the sale or exchange of a capital asset may be finally disallowed because of the operation of section 1211 does not mean that such loss is not "taken into account in computing taxable income" within the meaning of that phrase as used in sections 1222(2) and 1222(4).

(b) In the definition of "net short-term capital gain", as provided in section 1222(5), the amounts brought forward to the taxable year under section 1212 are short-term capital losses for such taxable year.

(c) Gains and losses from the sale or exchange of capital assets held for not more than six months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than six months (described as long-term capital gains and long-term capital losses).

(d) In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges, which losses include any amounts brought forward pursuant to section 1212. In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (1) the sum of the gains from sales or exchanges of capital assets, plus taxable income (computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions provided by section 151, relating to personal exemptions, or any deductions in lieu thereof) of the taxpayer or \$1,000, whichever is smaller, over (2) the losses from such sales or exchanges, which losses include amounts brought forward under section 1212. Thus, in the case of estates and trusts, taxable income for the purposes of section 1222(9) (B) (i) shall be computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions allowed by section 642(b) to estates and trusts in lieu of personal exemptions. In the case of a taxpayer whose tax liability is computed under section 3, the term "taxable income", for purposes of this paragraph, shall be read as "adjusted gross income." For application of the term "net capital gain," in computing the capital loss carryover under section 1212, see § 1.1212-1(b).

(e) The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. However, amounts which are short-term capital losses under section 1212 are excluded in determining such "net capital loss".

(f) See section 165(g) and section 166(e), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under sections 1201-1241 from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged. See also section 1231 and § 1.1231-1 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets. See also section 1236 and § 1.1236-1 for the determination of whether or not gains from the sale or exchange of securities by a dealer in securities shall be treated

as capital gains, or whether losses from such sales or exchanges shall be treated as ordinary losses.

(g) In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for the determination of the net amount of capital gains subject to tax.

## § 1.1223 STATUTORY PROVISIONS; HOLDING PERIOD OF PROPERTY.

### SEC. 1223. HOLDING PERIOD OF PROPERTY.

For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph—

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081(c) (or under section 112(g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under section 307 (or under so much of section 1052(c) as refers to section 113(a) (23) of the Internal Revenue Code of 1939), there shall (under regulations prescribed by the Secretary or his delegate) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution.

(6) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised.

(7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, there shall be included the period for which such other residence had been held as of the date of such sale or exchange.



For purposes of this paragraph, the term "sale or exchange" includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(8) In determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands.

(9) Any reference in this section to a provision of this title shall, where applicable, be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws.

(10) CROSS REFERENCE.—For special holding period provision relating to certain partnership distributions, see section 735(b).

§ 1.1223-1 DETERMINATION OF PERIOD FOR WHICH CAPITAL ASSETS ARE HELD.—(a) The holding period of property received in an exchange by a taxpayer includes the period for which the property which he exchanged was held by him, if the property received has the same basis in whole or in part for determining gain or loss in the hands of the taxpayer as the property exchanged. However, this rule shall apply, in the case of exchanges after March 1, 1954, only if the property exchanged was at the time of the exchange a capital asset in the hands of the taxpayer or property used in his trade or business as defined in section 1231(b). For the purposes of this paragraph the term "exchange" includes the following transactions: (1) An involuntary conversion described in section 1033, and (2) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies. Thus, if property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 1033(c) the same basis in whole or in part in the hands of the taxpayer as the property so converted, its acquisition is treated as an exchange and the holding period of the newly acquired property shall include the period during which the converted property was held by the taxpayer. Thus, also, where stock of a controlled corporation is received by a taxpayer pursuant to a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the distribution is treated as an exchange and the period for which the taxpayer has held the stock of the controlled corporation shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

(c) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081(c) (or under section

112(g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(d) If the acquisition of stock or securities resulted in the non-deductibility (under section 1091, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, the holding period of the newly acquired securities shall include the period for which the taxpayer held the securities with respect to which the loss was not allowable.

(e) The period for which the taxpayer has held stock, or stock subscription rights, received on a distribution shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is determined under section 307. If the basis of stock received by a taxpayer pursuant to a spin-off is determined under so much of section 1052(c) as refers to section 113(a)(23) of the Internal Revenue Code of 1939, and such stock is sold or otherwise disposed of in a taxable year which is subject to the Internal Revenue Code of 1954, the period for which the taxpayer has held the stock received in such spin-off shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(f) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

(g) The period for which the taxpayer has held a residence, the acquisition of which resulted under the provisions of section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, shall include the period for which such other residence had been held as of the date of such sale or exchange. See § 1.1034-1. For purposes of this paragraph, the term "sale or exchange" includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(h) If a taxpayer accepts delivery of a commodity in satisfaction of a commodity futures contract, the holding period of the commodity shall include the period for which the taxpayer held the commodity futures contract, if such futures contract was a capital asset in his hands.

(i) If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the rules prescribed by the regulations under section 1012 for determining the cost or other basis of such

stock so sold or transferred shall also apply for the purpose of determining the holding period of such stock.

(j) Any reference in section 1223 or this section to another provision of the Internal Revenue Code of 1954 is, where applicable, to be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws. The provisions of prior internal revenue laws here intended are the sections referred to in the sections of the 1939 Code which correspond to the sections of the 1954 Code referred to in section 1223. Thus, the sections corresponding to section 1081(c) are section 371(c) of the Revenue Act of 1938 and section 371(c) of the 1939 Code. The sections corresponding to section 1091 are section 118 of each of the following: The Revenue Acts of 1928, 1932, 1934, 1936, and 1938, and the 1939 Code.

#### SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

### § 1.1231 STATUTORY PROVISIONS; PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

#### SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For purposes of this section—

(1) GENERAL RULE.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year.

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) TIMBER OR COAL.—Such term includes timber and coal with respect to which section 631 applies.

(3) **LIVESTOCK.**—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) **UNHARVESTED CROP.**—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as “property used in the trade or business.”

§ 1.1231-1 **GAINS AND LOSSES FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.**—(a) *In general.*—Section 1231 provides that a taxpayer’s gains and losses from the disposition (including involuntary conversion) of assets described in that section as “property used in the trade or business” and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 6 months is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The non-capital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 6 months, other than stock in trade and certain copyrights and artistic property; (2) timber and coal, but only to the extent that section 631 applies thereto; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.*—For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from—

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231(d)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 6 months.

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of sections 1201 through 1212, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 6 months is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase “involuntary conversion” is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.*—Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 6 months and used in the taxpayer’s trade or business, which is either real property or is of a character subject

to the allowance for depreciation under section 167 (even though fully depreciated), and which is not—

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in section 1221 (3); or

(iii) Livestock held for draft, breeding, or dairy purposes, except to the extent included under subparagraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 6 months.

(3) The cutting or disposal of timber, or the disposal of coal, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231-2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 6 months, and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase "property used in the trade or business" means property described in this paragraph (other than property described in subparagraph (2) of this paragraph).

(d) *Extent to which gains and losses are taken into account.*—All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion.*—For purposes of section 1231, the § 1.1231-1(d)

terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money. For example, if a capital asset held for more than 6 months, with an adjusted basis of \$400, is stolen, and the loss is not compensated for by insurance or otherwise, section 1231 applies to the \$400 loss.

(f) *Unharvested crops*.—Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not "land" for the purpose of section 1231.

(g) *Examples*.—The provisions of this section may be illustrated by the following examples:

*Example (1)*. A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	<i>Gains</i>	<i>Losses</i>
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months .....	\$4,000	
2. Gain reported in 1957 (under sec. 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months) .....	6,000	
3. Gain reported in 1957 (under sec. 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks .....	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation.....	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.) .....		\$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months .....		5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for \$1,800 and having a fair market value of \$1,000 at the time of the storm .....		1,000
8. Total gains .....	\$12,500	
9. Total losses .....		\$9,000
10. Excess of gains over losses .....	3,500	

Since the aggregate of the recognized gains (\$12,500) exceeds the aggregate of the recognized losses (\$9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than six months.

*Example (2)*. If in example (1) A also had a loss of \$4,000 from the sale under threat of condemnation of a capital asset acquired for

profit and held for more than six months, then the gains (\$12,500) would not exceed the losses (\$9,000 plus \$4,000, or \$13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchange of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the \$4,000 loss would be treated as an ordinary loss.

*Example (3).* A's yacht, used for pleasure and acquired for that use in 1945 at a cost of \$25,000, was requisitioned by the Government in 1957 for \$15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

§ 1.1231-2 **LIVESTOCK HELD FOR DRAFT, BREEDING, OR DAIRY PURPOSES.**—(a) Section 1231 applies to the sale, exchange, or involuntary conversion of livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. For the purposes of section 1231, the term "livestock" is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b) Whether or not livestock is held by the taxpayer for draft, breeding, or dairy purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, or dairy purposes. However, an animal is not held by the taxpayer for draft, breeding, or dairy purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, or dairy purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held.

(c) These principles may be illustrated by the following examples:

*Example (1).* An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes.

*Example (2).* The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which

would have been used by him for breeding or dairy purposes if he had remained in business. These young animals are considered as held for breeding or dairy purposes. The same would be true with respect to young animals which would have been used by the taxpayer for breeding or dairy purposes but which are sold by him in reduction of his breeding or dairy herd because of, for example, drought.

*Example (3).* A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered as held for breeding purposes.

*Example (4).* A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses them for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling the animals, and, accordingly, these horses are not considered as held for draft purposes.

*Example (5).* The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice of this particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes. However, these cattle held by the taxpayer as additions or replacements to his own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

*Example (6).* A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows are not considered as held for breeding purposes.

## § 1.1232 STATUTORY PROVISIONS; BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

### SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) **GENERAL RULE.**—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) **RETIREMENT.**—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) **SALE OR EXCHANGE.**—

(A) **GENERAL RULE.**—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than



6 months, any gain realized which does not exceed an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidences of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

(B) EXCEPTIONS.—This paragraph shall not apply to—

(i) obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

(C) ELECTION AS TO INCLUSION.—In the case of obligations with respect to which the taxpayer has made an election provided by section 454(a) and (c) (relating to accounting rules for certain obligations issued at a discount), this section shall not require the inclusion of any amount previously includible in gross income.

(b) DEFINITIONS.—

(1) ORIGINAL ISSUE DISCOUNT.—For purposes of subsection (a), the term “original issue discount” means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term “stated redemption price at maturity” means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) ISSUE PRICE.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term “issue price” means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond. For purposes of this paragraph, the terms “initial offering price” and “price paid by the first buyer” include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

(3) ISSUE DATE.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term “date of original issue” means the date on which the issue was first sold to the public at the issue price. In the case of privately placed issues of bonds or other evidences of indebtedness, the term “date of original issue” means the date on which each such bond or other evidence of indebtedness was sold by the issuer.

(c) BOND WITH EXCESS NUMBER OF COUPONS DETACHED.—If—

(1) a bond or other evidence of indebtedness issued at any time with interest coupons is purchased after the date of enactment of this title, and

(2) the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, then the gain on the sale or other disposition of such evidence of indebtedness by such purchaser shall be considered as gain from the sale or exchange of property which is not a capital asset to the extent that the market value (determined as of the time of the purchase) of the evidence of indebtedness with coupons attached exceeds the purchase price. If this subsection and subsection (a) (2) (A) apply with respect to gain realized on the retirement of any bond, then subsection (a) (2) (A) shall apply with respect to that part of the gain to which this subsection does not apply.

(d) CROSS REFERENCE.—For special treatment of face-amount certificates on retirement, see section 72.

§ 1.1232-1 BOND AND OTHER EVIDENCES OF INDEBTEDNESS; SCOPE OF SECTION.—(a) *In general*.—Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§ 1.1232-2 through 1.1232-4 as an obligation) (1) which is a capital asset in the hands of the taxpayer, and (2) which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment; and section 1232(a)(2) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, a portion of the gain constitutes ordinary income. Section 1232(c) treats as ordinary income a portion of any gain realized upon the disposition of coupon obligations which were acquired without all coupons maturing more than 12 months after purchase attached.

(b) *Requirement that obligations be capital assets*.—In order for section 1232 to be applicable, an obligation must be a capital asset in the hands of the taxpayer. See section 1221 and the regulations thereunder. Obligations held by a dealer in securities (except as provided in section 1236) or obligations arising from the sale of inventory or personal services by the holder are not capital assets.

(c) *Face-amount certificates*.—The taxability of amounts received under “face-amount certificates”, as defined in sections 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U. S. C. 80a-2 and 80a-4) which are issued after December 31, 1954, is governed by section 72, rather than section 1232, and is, therefore, subject to the limit on tax provided by section 72(e)(3). See section 72(1).

§ 1.1232-2 RETIREMENT.—Section 1232(a)(1) provides that any amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor. However, section 1232(a)(1) does not apply to obligations issued before January 1, 1955, which were not issued with interest coupons or in registered form, or which were not in registered form on March 1, 1954. With respect to certain obligations held by a bank, see section 582(c).

§ 1.1232-3 GAIN UPON SALE OR EXCHANGE OF OBLIGATIONS ISSUED AT A DISCOUNT AFTER DECEMBER 31, 1954.—(a) *General rule*.—Section 1232(a)(2)(A) provides that gain realized upon the sale or exchange of obligations issued at a discount after December 31, 1954, and held by the taxpayer for more than six months, shall be considered ordinary income to the extent of the “original issue discount” recovered, and the balance of the gain shall be considered as long-term capital gain. The term “original issue discount” is defined in paragraph (b) of this section. The computation of the amount of original issue discount recovered is illustrated in paragraph (c) of this section. Whether gain representing original issue discount and realized upon the sale or exchange of obligations issued at a discount before January 1, 1955, is capital gain or ordinary income shall be determined without reference to section 1232.

(b) *Definitions*.—(1) *Original issue discount*.—For purposes of

§ 1.1232-3(b)(1)

section 1232, the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. The stated redemption price is determined without regard to optional call dates. If the original issue discount is less than one-fourth of one percent of the stated redemption price at maturity, multiplied by the number of full years from the date of original issue to maturity, then the discount shall be considered to be zero. For example, a 10-year bond with a stated redemption price at maturity of \$100 issued at \$98 would be regarded as having an original issue discount of zero. Thus, any gain realized by the holder would be a long-term capital gain if the bond was a capital asset in the hands of the holder and held by him for more than six months. However, if the bond were issued at \$97.50 or less, the original issue discount would not be considered zero. The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement, including dividends payable at that time. Thus, in the case of face-amount certificates, the redemption price at maturity is the price as modified through changes such as extensions of the purchase agreement and includes any dividends which are payable at maturity.

(2) *Issue price.*—The term "issue price" in the case of obligations registered with the Securities and Exchange Commission means the initial offering price to the public at which price a substantial amount of such obligations were sold. For this purpose, the term "the public" does not include bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. Ordinarily, the issue price will be the first price at which the obligations were sold to the public, and the issue price will not change if, due to market developments, part of the issue must be sold at a different price. When obligations are privately placed, the issue price of each obligation is the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue. The terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. Thus, all amounts paid by the purchaser under the purchase agreement or a modification of it are included in the issue price, such as amounts paid upon face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable with an increment at a later date.

(3) *Date of original issue.*—In the case of issues of obligations which are registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of issues which are privately placed, the term "date of original issue" means the date on which each obligation was sold to the original purchaser.

(c) *Computation of amount of original discount recovered.*—The amount of the original issue discount considered to be recovered by the holder is computed by multiplying the original issue discount by a fraction, the numerator of which is the number of full months the obligation was held by the holder and the denominator of which is the number of full months from the date of original issue to the date specified as the redemption date at maturity. (See paragraph (b) (3))

of this section for definition of "date of original issue".) The period that the obligation was held by the taxpayer shall include any period that it was held by another person if, under chapter 1 of the Internal Revenue Code of 1954, for the purpose of determining gain or loss from a sale or exchange, the bond has the same basis, in whole or in part, in the hands of the taxpayer as it would have in the hands of such other person. This computation is illustrated by the following examples:

*Example (1).* An individual purchases a 10-year, 3-percent coupon bond for \$900 on original issue on February 1, 1955, and sells it on February 20, 1960, for \$940. The redemption price is \$1,000. The bond has been held by the taxpayer for 60 full months. (The additional days amounting to less than a full month are not taken into account.) The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction  $60/120$  multiplied by the discount of \$100 is equal to \$50, which represents the proportionate part of the original issue discount attributable to the period of ownership by the taxpayer. Accordingly, any part of the gain up to \$50 will be treated as ordinary income. Therefore, in this case the entire gain of \$40 is treated as ordinary income.

*Example (2).* Assume the same facts in the preceding example, except that the selling price of the bond is \$970. In this case \$50 of the gain of \$70 is treated as ordinary income and the balance of \$20 is treated as long-term capital gain.

*Example (3).* Assume the same facts as in example (1), except that the selling price of the bond is \$800. In this case, the individual has a long-term capital loss of \$100.

*Example (4).* Assume the same facts as in example (1), except that the bond is purchased by the second holder February 1, 1960, for \$800. The second holder keeps it to the maturity date (February 1, 1965) when it is redeemed for \$1,000. Since that holder has held the bond for 60 full months, he will, upon redemption, have \$50 in ordinary income and \$150 in long-term capital gain.

(d) *Exceptions to the general rule.*—Section 1232(a)(2)(B) provides that section 1232(a)(2)(A) does not apply (1) to obligations the interest on which is excluded from gross income under section 103 (relating to certain government obligations), or (2) to any holder who purchased an obligation at a premium. For purposes of section 1232 and this section, "premium" means a purchase price which exceeds the stated redemption price of an obligation at its maturity. If, under chapter 1 of the Internal Revenue Code of 1954, the basis of an obligation in the hands of the holder is the same, in whole or in part, for the purposes of determining gain or loss from a sale or exchange, as the basis of the obligation in the hands of another person who purchased the obligation at a premium, then the holder shall be considered to have purchased the obligation at a premium. Thus, the donee of an obligation purchased at a premium by the donor will be considered a holder who purchased the obligation at a premium.

(e) *Amounts previously includible in income.*—Any amount previously includible in a taxpayer's income on account of obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals is not again includible in his gross income under sec-

tion 1232. For example, amounts includible in gross income by a cash receipts and disbursements method taxpayer who has made an election under section 454 (a) or (c) (relating to accounting rules for certain obligations issued at a discount) are not includible in gross income under section 1232. In the case of a gain which would include, under section 1232, an amount considered to be ordinary income and a further amount considered long-term capital gain, any amount to which this paragraph applies is first used to offset the amount considered ordinary income. For example, on January 1, 1955, A purchases a 10-year bond which is redeemable for fixed amounts increasing at stated intervals. The purchase price for the bond is \$75, which is also the issue price. The stated redemption price at maturity of the bond is \$100. A elects to treat the annual increase in the redemption price of the bond as income pursuant to section 454(a). On January 1, 1960, A sells the bond for \$90. The total stated increase in the redemption price of the bond which A has reported annually as income for the taxable years 1955 through 1959 is \$7. The portion of the original issue discount of \$25 attributable to this period is \$12.50, computed as follows:

$$\frac{60 \text{ (months bond is held by A)}}{120 \text{ (months from date of original issue to redemption date)}} \times \$25 \text{ (original issue discount)}$$

However, \$7, which represents the annual stated increase taken into income, is offset against the amount of \$12.50, leaving \$5.50 of the gain from the sale to be treated as ordinary income.

(f) *Record keeping requirements.*—In the case of any obligation held by a taxpayer which was issued at an original issue discount after December 31, 1954, the taxpayer shall keep a record of the issue price and issue date upon or with each such obligation (if known to or reasonably ascertainable by him). The issuer (or in the case of obligations first sold to the public through an underwriter or wholesaler, the underwriter or wholesaler) shall mark the issue price and issue date upon every obligation which is issued at an original issue discount after the publication of the regulations under section 1232 in the Federal Register.

§ 1.1232-4 OBLIGATIONS WITH EXCESS COUPONS DETACHED.—Section 1232(c) provides that if an obligation which is issued at any time with interest coupons is purchased after August 16, 1954, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, any gain on the later sale or other disposition of the obligation by the purchaser (or by a transferee of the purchaser whose basis is determined by reference to the basis of the purchaser) shall be treated as ordinary income to the extent that the fair market value of the obligation (determined as of the time of the purchase) with coupons attached exceeds the purchase price. If both the preceding sentence and section 1232(a)(2)(A) apply with respect to the gain realized on the retirement or other disposition of an obligation, then section 1232(a)(2)(A) shall apply only with respect to that part of the gain to which the preceding sentence does not apply. For example, a \$100 bond which sells at \$90 with all its coupons attached is purchased by A for \$80 with 3 years'

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coupons detached. Three years later, A sells the bond for \$92. The first \$10 of the \$12 profit is taxable as ordinary income. The remaining \$2 gain is taxable either as ordinary income or as long-term capital gain, depending upon the application of section 1232(a)(2)(A). Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, although such years as subject to the Internal Revenue Code of 1939.

## § 1.1234 STATUTORY PROVISIONS; OPTIONS TO BUY OR SELL.

### SEC. 1234. OPTIONS TO BUY OR SELL.

Gain or loss attributable to the sale or exchange of, or loss on failure to exercise, a privilege or option to buy or sell property which in the hands of the taxpayer constitutes (or if acquired would constitute) a capital asset shall be considered gain or loss from the sale or exchange of a capital asset; and, if the loss is attributable to failure to exercise such privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired. This section shall not apply to losses on failure to exercise options described in section 1233(c).

§ 1.1234-1 OPTIONS TO BUY OR SELL.—(a) *Sale or exchange.*—(1) *Capital assets.*—Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions.*—Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option, the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property.*—Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option.*—If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged upon the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. Any gain to the grantor of an option arising from the failure of the holder to exercise it is ordinary income.

(c) *Certain options to sell property at a fixed price.*—Section 1234 does not apply to a loss on the failure to exercise an option to sell property at a fixed price which is acquired on the same day on which the property identified as intended to be used in exercising the option is acquired. Such a loss is not recognized, but the cost of the option

is added to the basis of the property with which it is identified. See section 1233(c) and the regulations thereunder.

(d) *Dealers in options to buy or sell.*—Any gain or loss realized by a dealer in options from the sale or exchange of an option to buy or sell property is considered ordinary income or loss under paragraph (a) (3) of this section. A dealer in options to buy or sell property is considered a dealer in the property subject to the option.

(e) *Other exceptions.*—Section 1234 does not apply to gain resulting from the sale or exchange of an option—

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

(2) If the option is treated as section 306 stock (see section 306 and the regulations thereunder, relating to dispositions of certain stock); or

(3) To the extent that the gain is a distribution of earnings or profits taxable as a dividend (see section 301 and the regulations thereunder, relating to distributions of property).

(f) *Limitations on effect of section.*—Losses to which section 1234 applies are subject to the limitations on losses under sections 165 (c) and 1211 when applicable. Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of law. In addition, section 1234 does not apply to an option to lease property, but does apply to an option to buy or sell a lease. Thus, an option to obtain all the right, title, and interest of a lessee in leased property is subject to the provisions of section 1234, but an option to obtain a sublease from the lessee is not. Furthermore, if section 1234 applies to an option to buy or sell a lease, it is the character the lease itself, if acquired, would have in the hands of the taxpayer, and not the character of the property leased, which determines the treatment of gain or loss experienced by the taxpayer with respect to such an option.

(g) *Examples.*—The rules set forth in this section may be illustrated by the following examples:

*Example (1).* A taxpayer is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, the taxpayer decides he does not want the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

*Example (2).* Assume the same facts as in example (1), except that the property goes down in value, and the taxpayer decides not to purchase the house. He sells the option at a loss. While this is a capital loss under section 1234, it is not a deductible loss because of the provisions of section 165(c).

*Example (3).* A dealer in industrial property acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since he would have held the property for sale to customers in the ordinary course of his trade or business if he had acquired it.

# § 1.1235 STATUTORY PROVISIONS; SALE OR EXCHANGE OF PATENTS.

## SEC. 1235. SALE OR EXCHANGE OF PATENTS.

(a) **GENERAL.**—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

(b) **"HOLDER" DEFINED.**—For purposes of this section, the term "holder" means—

(1) any individual whose efforts created such property, or

(2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(A) the employer of such creator, nor

(B) related to such creator (within the meaning of subsection (d)).

(c) **EFFECTIVE DATE.**—This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) **RELATED PERSONS.**—Subsection (a) shall not apply to any sale or exchange between an individual and any other related person (as defined in section 267(b)), except brothers and sisters, whether by the whole or half blood.

(e) **CROSS REFERENCE.**—For special rule relating to nonresident aliens, see section 871(a).

§ 1.1235-1 **SALE OR EXCHANGE OF PATENTS.**—(a) *General rule.*—Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than six months, whether or not payments therefor are—

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *Scope of section 1235.*—If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

(c) *Special rules.*—(1) *Payments for infringement.*—If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. See section 1304 and the



regulations thereunder for treatment of compensatory damages for patent infringement.

(2) *Payments to an employee.*—Payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies. However, whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under section 1235 are met, such payments shall be treated as proceeds derived from the sale of a patent.

(3) *Successive transfers.*—The applicability of section 1235 to transfers of undivided interest in patents, or to successive transfers of such rights, shall be determined separately with respect to each transfer. For example, X, who is a holder, and Y, who is not a holder, transfer their respective  $\frac{2}{3}$  and  $\frac{1}{3}$  undivided interests in a patent to Z. Assume the transfer by X qualifies under section 1235 and that X in a later transfer acquires all the rights with respect to Y's interest, including the rights to payments from Z. One-third of all the payments thereafter received by X from Z are not attributable to a transfer to which section 1235 applies.

(d) *Payor's treatment of payments in a transfer under section 1235.*—Payments made by the transferee of patent rights pursuant to a transfer satisfying the requirements of section 1235 are payments of the purchase price for the patent rights and are not the payment of royalties.

(e) *Effective date.*—Amounts received or accrued, and payments made or accrued, during any taxable year beginning after December 31, 1953, and ending after August 16, 1954, pursuant to a transfer satisfying the requirements of section 1235, whether such transfer occurred in a taxable year to which the Internal Revenue Code of 1954 applies, or in a year prior thereto, are subject to the provisions of section 1235.

(f) *Nonresident aliens.*—For the special rule relating to nonresident aliens who have gains arising from a transfer to which section 1235 applies, see section 871 and the regulations thereunder. For withholding of tax from income of nonresident aliens, see section 1441 and the regulations thereunder.

§ 1.1235-2 DEFINITION OF TERMS.—For the purposes of section 1235 and § 1.1235-1—

(a) *Patent.*—The term "patent" means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent

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granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) *All substantial rights to a patent.*—(1) The term “all substantial rights to a patent” means all rights which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of all substantial rights to a patent.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor’s lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of all substantial right for the purposes of section 1235.

(c) *Undivided interest.*—A person owns an “undivided interest” in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) *Holder.*—(1) The term “holder” means any individual—

(i) Whose efforts created the patent property and who would qualify as the “original and first” inventor, or joint inventor, within the meaning of title 35 of the United States Code, or

(ii) Who has acquired his interest in the patent property in exchange for a consideration paid to the inventor in money or money’s worth prior to the actual reduction of the invention to practice (see paragraph (e) of this section), provided that such individual was neither the employer of the inventor nor related to him (see paragraph

(f) of this section). The requirement that such individual is neither the employer of the inventor nor related to him must be satisfied at the time when the substantive rights as to the interest to be acquired are determined, and at the time when the consideration in money or money's worth to be paid is definitely fixed. For example, if prior to the actual reduction to practice of an invention an individual who is neither the employer of the inventor nor related to him agrees to pay the inventor a sum of money definitely fixed as to amount in return for an undivided one-half interest in rights to a patent and at a later date, when such individual has become the employer of the inventor, he pays the definitely fixed sum of money pursuant to the earlier agreement, such individual will not be denied the status of a holder because of such employment relationship.

(2) Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than six months.

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(e) *Actual reduction to practice.*—For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term "actual reduction to practice" has the same meaning as it does under section 102(g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

(f) *Related persons.*—(1) The term "related person" means one whose relationship to another person at the time of the transfer is described in section 267(b), except that the term does not include a brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person. However, if a holder transfers all his substantial rights to a patent to a corporation in which he owns more than 50 percent in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other hand, if a holder transfers all his substantial rights to a patent to a corporation in which he owns 50 percent or less in value of the outstanding stock and his brother owns the remaining stock, he is not considered as transferring

such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(2) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception, described in subparagraph (1) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235(d). (See section 267(b)(4).) The transfer, therefore, would not qualify under section 1235(a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

## § 1.1236 STATUTORY PROVISIONS; DEALERS IN SECURITIES.

### SEC. 1236. DEALERS IN SECURITIES.

(a) CAPITAL GAINS.—Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—

(1) the security was, before the expiration of the 30th day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) the security was not, at any time after the expiration of such 30th day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(b) ORDINARY LOSSES.—Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in section 582(c), (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment.

(c) DEFINITION OF SECURITY.—For purposes of this section, the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

§ 1.1236-1 DEALERS IN SECURITIES.—(a) *Capital gains*.—Section 1236(a) provides that gain realized by a dealer in securities from the sale or exchange of a security (as defined in paragraph (c) of this section) shall not be considered as gain from the sale or exchange of a capital asset unless—

(1) The security is, before the expiration of the thirtieth day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or, if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) The security is not held by the dealer primarily for sale to customers in the ordinary course of his trade or business at any time after the identification referred to in subparagraph (1) of this paragraph has been made.

Unless both of these requirements are met, the gain is considered as gain from the sale of assets held by the dealer primarily for sale to customers in the course of his business.

(b) *Ordinary losses*.—Section 1236(b) provides that a loss sustained by a dealer in securities from the sale or exchange of a security shall

not be considered a loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security has been clearly identified in the dealer's records as a security held for investment. Once a security has been identified after November 19, 1951, as being held by the dealer for investment, it shall retain that character for purposes of determining loss on its ultimate disposition, even though at the time of its disposition the dealer holds it primarily for sale to his customers in the ordinary course of his business. However, section 1236 has no application to the extent that section 582(c) applies to losses of banks.

(c) *Definitions.*—(1) *Security.*—For the purposes of this section, the term "security" means any share of stock in any corporation, any certificate of stock or interest in any corporation, any note, bond, debenture, or other evidence of indebtedness, or any evidence of any interest in, or right to subscribe to or purchase, any of the foregoing.

(2) *Dealer in securities.*—For definition of a "dealer in securities", see the regulations under section 471.

(d) *Identification of security in dealer's records.*—(1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by (i) making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment, and (ii) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security.

(2) In computing the 30-day period prescribed by section 1236 (a), the first day of the period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1957, the 30-day period expires at midnight on April 17, 1957.

## § 1.1237 STATUTORY PROVISIONS; REAL PROPERTY SUBDIVIDED FOR SALE.

### SEC. 1237. REAL PROPERTY SUBDIVIDED FOR SALE.

(a) *GENERAL.*—Any lot or parcel which is part of a tract of real property in the hands of a taxpayer (including corporations only if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business and only in the case of property described in the last sentence of subsection (b) (3)) shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if—

(1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) or, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by—

(A) the taxpayer or members of his family (as defined in section 267(c)(4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

## § 1.1236-1(c)(1)

(B) a lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

(b) SPECIAL RULES FOR APPLICATION OF SECTION.—

(1) GAINS.—If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2) and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) EXPENDITURES OF SALE.—For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) NECESSARY IMPROVEMENT.—No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if—

(A) such improvement is the building or installation of water, sewer, or drainage facilities or roads (if such improvement would except for this paragraph constitute a substantial improvement);

(B) it is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

The requirements of subparagraphs (B) and (C) shall not apply in the case of property acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property described in the first part of this sentence.

(c) TRACT DEFINED.—For purposes of this section, the term "tract of real property" means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) EFFECTIVE DATE.—This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots

and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

[Sec. 1237 as amended by Public Law 495 (84th Cong.) [70 Stat. 118] for taxable years beginning after December 31, 1954.]

§ 1.1237-1 REAL PROPERTY SUBDIVIDED FOR SALE.—(a) *General rule.*—(1) *Introductory.*—This section provides a special rule for determining whether the taxpayer holds real property primarily for sale to customers in the ordinary course of his business under section 1221(1). This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to dealers in real estate or to corporations, except a corporation making such sales in a taxable year beginning after December 31, 1954, if such corporation qualifies under the provisions of paragraph (c)(5)(iv) of this section.

(2) *When subdividing and selling activities are to be disregarded.*—When its conditions are met, section 1237 provides that if there is no other substantial evidence that a taxpayer holds real estate primarily for sale to customers in the ordinary course of his business, he shall not be considered a real estate dealer holding it primarily for sale merely because he has (i) subdivided the tract into lots (or parcels) and (ii) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision. Such subdividing and selling activities shall be disregarded in determining the purpose for which the taxpayer held real property sold from a subdivision whenever it is the only substantial evidence indicating that the taxpayer has ever held the real property sold primarily for sale to customers in the ordinary course of his business.

(3) *When subdividing and selling activities are to be taken into account.*—When other substantial evidence tends to show that the taxpayer held real property for sale to customers in the ordinary course of his business, his activities in connection with the subdivision and sale of the property sold shall be taken into account in determining the purpose for which the taxpayer held both the subdivided property and any other real property. For example, such other evidence may consist of the taxpayer's selling activities in connection with other property in prior years during which he was engaged in subdividing or selling activities with respect to the subdivided tract, his intention in prior years (or at the time of acquiring the property subdivided) to hold the tract primarily for sale in his business, his subdivision of other tracts in the same year, his holding other real property for sale to customers in the same year, or his construction of a permanent real estate office which he could use in selling other real property. On the other hand, if the only evidence of the taxpayer's purpose in holding real property consisted of not more than one of the following, in the year in question, such fact would not be considered substantial other evidence:

- (i) Holding a real estate dealer's license;
- (ii) Selling other real property which was clearly investment property;

(iii) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(iv) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it. If more than one of the above exists, the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case.

(4) *Section 1237 not exclusive.*—(i) The rule in section 1237 is not exclusive in its application. Section 1237 has no application in determining whether or not real property is held by a taxpayer primarily for sale in his business if any requirement under the section is not met. Also, even though the conditions of section 1237 are met, the rules of section 1237 are not applicable if without regard to section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business. Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. Furthermore, whether or not the conditions of section 1237 are met, the section has no application to losses realized upon the sale of realty from subdivided property.

(ii) If, owing solely to the application of section 1237, the real property sold is deemed not to have been held primarily for sale in the ordinary course of business, any gain realized upon such sale shall be treated as ordinary income to the extent provided in section 1237(b) (1) and (2) and paragraph (e) of this section. Any additional gain realized upon the sale shall be treated as gain arising from the sale of a capital asset or, if the circumstances so indicate, as gain arising from the sale of real property used in the trade or business as defined in section 1231(b) (1). For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(5) *Principal conditions of qualification.*—Before section 1237 applies, the taxpayer must meet three basic conditions, more fully explained later: He cannot have held any part of the tract at any time previously for sale in the ordinary course of his business, nor in the year of sale held any other real estate for sale to customers; he cannot make substantial improvements on the tract which increase the value of the lot sold substantially; and he must have owned the property 5 years, unless he inherited it. However, the taxpayer may make certain improvements if they are necessary to make the property marketable if he elects neither to add their cost to the basis of the property, or of any other property, nor to deduct the cost as an expense, and he has held the property at least 10 years. If the requirements of section 1237 are met, gain (but not more than 5 percent of the selling price of each lot) shall be treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

(b) *Disqualification arising from holding real property primarily for sale.*—(1) *General rule.*—Section 1237 does not apply to any transaction if the taxpayer either—

(i) Held the lot sold (or the tract of which it was a part) primarily for sale in the ordinary course of his business in a prior year, or



(ii) Holds other real property primarily for sale in the ordinary course of his business in the same year in which such lot is sold.

Where either of these elements is present, section 1237 shall be disregarded in determining the proper treatment of any gain arising from such sale.

(2) *Method of applying general rule.*—For purposes of this paragraph, in determining whether the lot sold was held primarily for sale in the ordinary course of business in a prior year, the principles of section 1237 shall be applied, whether or not section 1237 was effective for such prior year, if the sale of the lot occurs after December 31, 1953, or, in the case of a corporation meeting the requirements of paragraph (c) (5) (iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Whether, on the other hand, the taxpayer holds other real property for sale in the ordinary course of his business in the same year such lot was sold shall be determined without regard to the application of section 1237 to such other real property.

(3) *Attribution rules with respect to the holding of property.*—The taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. See, however, paragraph (c) (5) (iv) (c) of this section for an exception to this rule. The purpose for which a prior owner held the lot or tract, or his activities, are immaterial except to the extent they indicate the purpose for which the taxpayer has held the lot or tract. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held. The principles of this subparagraph may be illustrated by the following example:

*Example.* A dealer in real property held a tract of land for sale to customers in the ordinary course of his business for 5 years. He then made a gift of it to his son. As a result of the operation of section 1223 (2) the son will have held the property for the period of time required by section 1237. However, he will not qualify for the benefits of section 1237 because, there being no evidence to the contrary, the circumstances involved establish that the son holds the property for sale to customers, as did his father.

(c) *Disqualification arising from substantial improvements.*—(1) *General rule.*—Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237 (a) (2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237 (b) (3). See subparagraph (5) of this paragraph.

(2) *Improvements made or deemed to be made by the taxpayer.*—Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.

(i) For the purposes of section 1237 (a) (2) the taxpayer is deemed § 1.1237-1(b) (2)

to have made any improvements on the tract while he held it which are made by:

(a) The taxpayer's whole or half brothers and sisters, spouse, ancestors, and lineal descendants.

(b) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation's voting stock.

(c) A partnership of which the taxpayer was a member at the time the improvements were made.

(d) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.

(e) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.

(ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract, but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237(a)(2) he is deemed to have made the substantial improvements made by his father, and under section 1223(2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.

(a) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

*Example.* In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in comput-

ing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

(b) An improvement is made pursuant to a contract if the contract imposes an obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

*Example.* B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from building any structure on his lot except a personal residence costing \$15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

(iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a)(2) do not preclude the use of section 1237.

(3) *When improvements substantially enhance the value of the lot sold.*—Before a substantial improvement will preclude the use of section 1237, it must substantially enhance the value of the lot sold.

(i) The increase in value to be considered is only the increase attributable to the improvement or improvements. Other changes in the market price of the lot, not arising from improvements made by the taxpayer, shall be disregarded. The difference between the value of the lot, including improvements, when the improvement has been completed and an appraisal of its value if unimproved at that time, will disclose the value added by the improvements.

(ii) Whether improvements have substantially increased the value of a lot depend upon the circumstances in each case. If improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.

(iii) Improvements may increase the value of some lots in a tract without equally affecting other lots in the same tract. Only the lots whose value was substantially increased are ineligible for application of the rule established by section 1237.

(4) *When an improvement is substantial.*—To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, levelling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads were required by the climate, are not substantial improvements.

(5) *Special rules relating to substantial improvements.*—Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of

section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances, elect to have substantial improvements treated as necessary and not substantial.

(i) *When an improvement is not considered substantial.*—An improvement will not be considered substantial if all of the following conditions are met:

(a) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(b) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.

(c) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.

(d) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

(ii) *Meaning of "similar building site".*—A "similar building site" is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (a) the value of the taxpayer's property in an unimproved state with (b) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

*Example (1).* A has been offered \$500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for \$4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is \$2,500 per acre. The prevailing local price for similar building sites in the vicinity would be \$1,500 per acre (i. e., \$4,000 less \$2,500). If A installed roads and water facilities at a cost of

\$2,500 per acre, his tract would sell for approximately \$4,000 per acre. Under section 1237(b)(3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements (\$2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

*Example (2).* Assume the same facts as in example (1) of this subdivision except that A can obtain \$1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237(b)(3), since the prevailing local price could have been obtained without any improvement.

*Example (3).* Assume the same facts as in example (1) of this subdivision except that the adjacent tract has also been improved with sewer facilities, the present cost of which is \$1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237(b)(3) on A's part, since the prevailing local price (\$4,000 less the sum of \$1,200 plus \$2,500, or \$300) could have been obtained by A without any improvement.

(iii) *Manner of making election.*—The election required by section 1237(b)(3)(C) shall be made as follows:

(a) The taxpayer shall submit:

(1) A plat showing the subdivision and all improvements attributable to him.

(2) A list of all improvements to the tract, showing:

(i) The cost of such improvements.

(ii) Which of the improvements, without regard to the election, he considers "substantial" and which he considers "not substantial".

(iii) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.

(iv) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (iii) of this subdivision.

(3) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to subdivision (2)(iii) of this subdivision or which the district director deems substantial.

(b) The election and the information required under subdivision (a) of this subdivision shall be submitted to the district director—

(1) With the taxpayer's income tax return for the taxable year to which the lots subject to the election were sold, or

(2) In the case of a return filed prior to the publication in the Federal Register of the regulations under section 1237 following their adoption, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, within 90 days after such adoption, where such benefits have been claimed, or

(3) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(c) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocably and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain, the cost or other basis shall be computed without regard to section 1237.

(iv) *Exceptions with respect to "necessary" improvements and certain corporations.*—For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (c) and (d), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if—

(a) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,

(b) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and

(c) In the case of a corporate taxpayer, no share holder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision (iv), would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of subdivisions (a) and (b) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.

(d) *Holding period required.*—(1) *General rules.*—To apply section 1237, the taxpayer must either have inherited the lot sold or have held it for 5 years. Generally, the provision of section 1223 are applicable in determining the period for which the taxpayer has held the property. The provisions of this subparagraph may be illustrated by the following examples:

*Example (1).* A held a tract of land for 3 years under circumstances otherwise qualifying for section 1237 treatment. He made a gift of the tract to B at a time when the fair market value of the tract exceeded A's basis for the tract. B held the tract for 2 more years under similar circumstances. B then sold 4 lots from the tract. B is entitled to the benefits of section 1237 since under section 1223(2) he held the lots for 5 years and all the other requirements of section 1237 are met.

*Example (2).* C purchased all the stock in a corporation in 1955. The corporation purchased an unimproved tract of land in 1957. In 1961 the corporation was liquidated under section 333 and C acquired the tract of land. For purposes of section 1237, C's holding period commenced on the date the corporation actually acquired the land in 1957 and not on the date C purchased the stock.

(2) *Rules relating to property acquired upon death.*—If the taxpayer inherited the property there is no 5-year holding period required under section 1237. However, any holding period required by any other provision of the Internal Revenue Code of 1954, such as section 1222, is nevertheless applicable. For purposes of section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, is properly acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.

(e) *Tax consequences if section 1237 applies.*—(1) *Introductory.*—Where there is no substantial evidence other than subdivision and related selling activities that real property is held for sale in the ordinary course of taxpayer's business and section 1237 applies, section 1237(b)(1) provides a special rule for computing taxable gain. For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(2) *Characterization of gain and its relation to selling expenses.*—

(i) When the taxpayer has sold less than 6 lots or parcels from the same tract up to the end of his taxable year, the entire gain will be capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel. The following example illustrates this rule:

*Example.* A meets all the conditions of section 1237 in subdividing and selling a single tract. In 1956 he sells 4 lots to B, C, D, and E. In the same year F buys 3 adjacent lots. Since A has sold only 5 lots or parcels from the tract, any gain A realizes on the sales will be capital gain.

(ii) If the taxpayer has sold the sixth lot or parcel from the same tract within the taxable year, then the amount, if any, by which 5 percent of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange, shall, to the extent it represents gain, be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) Five percent of the selling price of each lot sold from the tract in the taxable year the sixth lot is sold and thereafter is, to the extent it represents gain, considered ordinary income. However, all expenses of sale of the lot are to be deducted first from the 5 percent of the gain which would otherwise be considered ordinary income, and any remainder of such expenses shall reduce the gain upon the sale or exchange which would otherwise be considered capital gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5-percent rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first 6 lots of a

single tract in one year, 5 percent of the selling price of each lot sold shall be treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first 3 lots of a single tract in 1955, and the next 3 lots in 1956, only the gain realized from the sale made in 1956 shall be so treated. For the effect of a 5-year interval between sales, see paragraph (g) (2) of this section. The operation of this subdivision may be illustrated by the following examples:

*Example (1).* Assume the selling price of the sixth lot of a tract is \$10,000, the basis of the lot in the hands of the taxpayer is \$5,000, and the expenses of sale are \$750. The amount of gain realized by the taxpayer is \$4,250, of which the amount of ordinary income attributable to the sale is zero, computed as follows:

Selling price .....	\$10,000	
Basis .....	5,000	
		<hr/>
Excess over basis .....		\$5,000
5 percent of selling price .....	\$500	
Expenses of sale .....	750	
		<hr/>
Amount of gain realized treated as ordinary income.....		\$0
Excess over basis .....		5,000
5 percent of selling price .....	\$500	
Excess of expenses over 5 percent of selling price.....	250	750
		<hr/>
Amount of gain realized from sale of property not held for sale in ordinary course of business.....		\$4,250

*Example (2).* Assume the same facts as in example (1), except that the expenses of sale of such sixth lot are \$300. The amount of gain realized by the taxpayer is \$4,700, of which the amount of ordinary income attributable to the sale is \$200, computed as follows:

Selling price .....	\$10,000	
Basis .....	5,000	
		<hr/>
Excess over basis .....		\$5,000
5 percent of selling price .....	\$500	
Expenses of sale .....	300	
		<hr/>
Amount of gain realized treated as ordinary income.....		\$200
Excess over basis .....		5,000
5 percent of selling price.....	\$500	
Excess of expenses over 5 percent of selling price.....	0	500
		<hr/>
Amount of gain realized from sale of property not held for sale in ordinary course of business.....		\$4,500

(iii) In the case of an exchange, the term "selling price" shall mean the fair market value of property received plus any sum of money received in exchange for the lot. See section 1031 for those exchanges in which no gain is recognized. For the purpose of subsections (b) and (c) of section 1237 and paragraphs (e) and (g) of this section, an exchange shall be treated as a sale or exchange whether or not gain or loss is recognized with respect to such exchange.

(f) *Relationship of section 1237 and section 1231.*—Application of section 1237 to a sale of real property may, in some cases, result in the property being treated as real property used in the trade or busi-



ness, as described in section 1231(b)(1). Thus, assuming section 1237 is otherwise applicable, if the lot sold would be considered property described in section 1231(b)(1) except for the fact that the taxpayer subdivided the tract of which it was a part, then evidence of such subdivision and connected sales activities shall be disregarded and the lot sold shall be considered real property used in the trade or business. Under such circumstances, any gain or loss realized from the sale shall be treated as gain or loss arising from the sale of real property used in the trade or business.

(g) *Definition of "tract".*—(1) *Aggregation of properties.*—For the purposes of section 1237, the term "tract" means either (i) a single piece of real property or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream, or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece or contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

(2) *When a subdivision will be considered a new tract.*—If the taxpayer sells or exchanges no lots from the tract for a period of 5 years after the sale or exchange of at least 1 lot in the tract, then the remainder of the tract shall be deemed a new tract for the purpose of counting the number of lots sold from the same tract under section 1237(b)(1). The pieces in the new tract need not be contiguous. The 5-year period is measured between the dates of the sales or exchanges.

(h) *Effective date.*—This section shall apply only to gain realized on sales made after December 31, 1953, or, in the case of a person meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section (other than subdivision (iv) of paragraph (c)(5)) shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939. Irrespective of whether the taxable year involved is subject to the Internal Revenue Code of 1939 or 1954, sales or exchanges made before January 1, 1954, shall be taken into account to determine whether: (1) No sales or exchanges have been made for 5 years, under section 1237(c), and (2) more than 5 lots or parcels have been sold or exchanged from the same tract, under section 1237(b)(1). Thus, if the taxpayer sold 5 lots from a single tract in 1950, and another lot is sold in 1954, the lot sold in 1954 constitutes the "sixth lot" sold from the original tract. On the other hand, if the first 5 lots were sold in 1948, the sale made in 1954 shall be deemed to have been made from a new tract.

# § 1.1238 STATUTORY PROVISIONS; AMORTIZATION IN EXCESS OF DEPRECIATION.

## SEC. 1238. AMORTIZATION IN EXCESS OF DEPRECIATION.

Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 168 (relating to amortization deduction of emergency facilities), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

§ 1.1238-1 AMORTIZATION IN EXCESS OF DEPRECIATION.—(a) *In general.*—Section 1238 provides that if a taxpayer is entitled to a deduction for amortization of an emergency facility under section 168, and if the facility is later sold or exchanged, any gain realized shall be considered as ordinary income to the extent that the amortization deduction exceeds normal depreciation. Thus, under section 1238 gain from a sale or exchange of property shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168. If an entire facility is certified under section 168(e), the taxpayer may use allowances for depreciation based on any rate and method which would have been proper if the basis of the facility were not subject to amortization under section 168, in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. If only a portion of a facility is certified under section 168(e), allowances for depreciation based on the rate and method properly used with respect to the uncertified part of the facility are used in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. The principles of this paragraph may be illustrated by the following examples:

*Example (1).* On December 31, 1954, a taxpayer making his income tax returns on a calendar year basis acquires at a cost of \$20,000 an emergency facility (used in his business) 50 percent of the adjusted basis of which has been certified under section 168(e). The facility would normally have a useful life of 20 years. Under section 168 the taxpayer elects to begin the 60-month amortization period on January 1, 1955. He takes amortization deductions with respect to the certified portion in the amount of \$4,000 for the years 1955 and 1956 (24 months). With respect to the uncertified portion, the straight line method of depreciation is used and a deduction for depreciation in the amount of \$1,000 is claimed and allowed for the years 1955 and 1956 (2 years at \$500). On December 31, 1956, he sells the facility for \$19,000. The adjusted basis of the certified portion on that date is \$6,000 (\$10,000 cost, less \$4,000 amortization). Without regard to section 168, and using the rate and method the taxpayer properly applied to the uncertified portion of the facility, the adjusted basis of the certified portion on December 31, 1956, would be \$9,000 (\$10,000 cost, less \$1,000 depreciation). The difference between the facility's actual adjusted basis (\$15,000) and its adjusted basis determined without regard to section 168 (\$18,000), is \$3,000. Accordingly, \$3,000 of the \$4,000 gain on the sale of the facility (\$19,000 sale price, less \$15,000 adjusted basis)

is treated as ordinary income and the remaining \$1,000 gain is subject to the provisions of section 1231.

*Example (2).* Assume that the entire facility in example (1) had been certified under section 168(e) and that, therefore, the adjusted basis of the facility on December 31, 1956, is \$12,000. Assume further that the taxpayer adopts straight line depreciation as a proper method of depreciation for determining the adjusted basis of the facility without regard to section 168. Thus, the adjusted basis, without regard to section 168, would be \$18,000. This amount is \$6,000 more than the \$12,000 adjusted basis under section 168. Hence, \$6,000 of the \$7,000 gain on the sale of the facility (\$19,000 sale price less \$12,000 adjusted basis) is treated as ordinary income, and the remaining \$1,000 gain is subject to the provisions of section 1231.

(b) *Substituted basis.*—If a taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed or allowable, and if the basis in his hands of the other property is determined by reference to the basis of the emergency facility, then the basis of the other property is determined with regard to section 168, and therefore the provisions of section 1238 apply with respect to gain realized on a subsequent sale or exchange of the other property. The provisions of section 1238 also apply to gain realized on the sale or exchange of an emergency facility (or other property acquired, as described in the preceding sentence, in exchange for an emergency facility) by a taxpayer in whose hands the basis of the facility (or other property) is determined by reference to its basis in the hands of another person to whom deductions were allowable or allowed with respect to the facility under section 168.

#### § 1.1239 STATUTORY PROVISIONS; GAIN FROM SALE OF CERTAIN PROPERTY BETWEEN SPOUSES OR BETWEEN AN INDIVIDUAL AND A CONTROLLED CORPORATION.

##### SEC. 1239. GAIN FROM SALE OF CERTAIN PROPERTY BETWEEN SPOUSES OR BETWEEN AN INDIVIDUAL AND A CONTROLLED CORPORATION.

(a) *TREATMENT OF GAIN AS ORDINARY INCOME.*—In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

(1) between a husband and wife; or

(2) between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren; any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) *SECTION APPLICABLE ONLY TO SALES OR EXCHANGES OF DEPRECIABLE PROPERTY.*—This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

§ 1.1239-1 *GAIN FROM SALE OR EXCHANGE OF CERTAIN PROPERTY BETWEEN SPOUSE OR BETWEEN AN INDIVIDUAL AND A CONTROLLED CORPORATION.*—Section 1239 provides in general that any gain from the sale or exchange of depreciable property between a husband and wife or between an individual and a controlled corporation shall be

§ 1.1238-1(b)

treated as ordinary income. Thus, any gain recognized to the transferor from a sale or exchange after May 3, 1951, directly or indirectly, between a husband and wife or between an individual and a controlled corporation, of property which, in the hands of the transferee, is property of a character subject to an allowance for depreciation provided in section 167 (including such property on which a deduction for amortization is allowable under section 168 or 169) shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. For the purpose of section 1239, a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren. For the purpose of this section, the terms "children" and "grandchildren" include legally adopted children and their children. The provisions of section 1239(a)(2) are applicable whether property is transferred from a corporation to a shareholder or from a shareholder to a corporation.

#### § 1.1240 STATUTORY PROVISIONS; TAXABILITY TO EMPLOYEE OF TERMINATION PAYMENTS.

##### SEC. 1240. TAXABILITY TO EMPLOYEE OF TERMINATION PAYMENTS.

Amounts received from the assignment or release by an employee, after more than 20 years' employment, of all his rights to receive, after termination of his employment and for a period of not less than 5 years (or for a period ending with his death), a percentage of future profits or receipts of his employer shall be considered an amount received from the sale or exchange of a capital asset held for more than 6 months if—

- (1) such rights were included in the terms of the employment of such employee for not less than 12 years,
- (2) such rights were included in the terms of the employment of such employee before the date of enactment of this title, and
- (3) the total of the amounts received for such assignment or release is received in one taxable year and after the termination of such employment.

§ 1.1240-1 CAPITAL GAINS TREATMENT OF CERTAIN TERMINATION PAYMENTS.—Any amounts received by an employee for the assignment or release of all his rights to receive, after termination of his employment and for a period of not less than five years or for a period ending with his death, a percentage of the profits or receipts of his employer attributable to a time subsequent to such termination, are considered received from the sale or exchange of a capital asset held for more than six months if the following requirements are met:

- (a) The employee was employed by the employer, in whose future profits or receipts the employee had an interest, for a period of more than 20 years before the assignment or release by the employee of his rights in such future profits or receipts.
- (b) The full rights of the employee to the percentage of the future profits or receipts of such employer, which rights are the subject of the assignment or release, were incorporated in the terms of the contract of employment between the employee and the employer for a period at least 12 years, and were so incorporated before August 16, 1954.

(c) The assignment or release was made after the termination of the employee's employment with such employer.

(d) The assignment or release conveyed all the rights of the employee in the future profits or receipts of such employer and conveyed no other rights of the employee, and

(e) The total amount to which the employee became entitled pursuant to the assignment or release was received by the employee after the termination of his employment with such employer and one taxable year of the employee.

The requirement that the assignment or release be made after the termination of the employee's employment contemplates a complete and bona fide termination of the relationship of employer and employee. This requires more than a mere termination of such relationship under the particular contract or contracts of employment pursuant to which the employee acquired his rights in the future profits or receipts of the employer. The contract need not expressly provide that the employee shall share in the future profits or receipts of the employer for a minimum period of five years. However, if the contract does not expressly so provide and the assignment or release is made before the expiration of five years following the termination of employment, the terms of the contract considered in conjunction with the facts in the particular situation must establish that the rights of the employee to a percentage of future profits or receipts, in all probability, will extend to a period of not less than five years from the date of termination of employment or for a period ending with his death. Section 1240 has application only to an assignment or release made by the employee who acquired the right to a percentage of future profits or receipts of the employer, and has no application to amounts received other than as payment for assignment or release of such right. Section 1240 has no effect upon the determination of the income tax of the employer making the payment to the employee.

#### § 1.1241 STATUTORY PROVISIONS; CANCELLATION OF LEASE OR DISTRIBUTOR'S AGREEMENT.

##### SEC. 1241. CANCELLATION OF LEASE OR DISTRIBUTOR'S AGREEMENT.

Amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement.

##### § 1.1241-1 CANCELLATION OF LEASE OR DISTRIBUTOR'S AGREEMENT.—

(a) *In general.*—Section 1241 provides that proceeds received by lessees or distributors from the cancellation of leases or of certain distributorship agreements are considered as amounts received in exchange therefor. Section 1241 applies to leases of both real and personal property. Distributorship agreements to which section 1241 applies are described in paragraph (c) of this section. Section 1241 has no application in determining whether or not a cancellation not qualifying under that section is a sale or exchange. Further, section 1241 has no application in determining whether or not a lease or a

distributorship agreement is a capital asset, even though its cancellation qualifies as an exchange under section 1241.

(b) *Definition of "cancellation".*—The term "cancellation" of a lease or a distributor's agreement, as used in section 1241, means a termination of all the contractual rights of a lessee or distributor with respect to particular premises or a particular distributorship, other than by the expiration of the lease or agreement in accordance with its terms. A payment made in good faith for a partial cancellation of a lease or a distributorship agreement is recognized as an amount received for cancellation under section 1241 if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease, a reduction in the unexpired term of a lease or distributorship agreement, or a distributorship in one of several areas or of one of several products. Payments made for other modifications of leases or distributorship agreements, however, are not recognized as amounts received for cancellation under section 1241.

(c) *Amounts received upon cancellation of a distributorship agreement.*—Section 1241 applies to distributorship agreements only if they are for marketing or marketing and servicing of goods. It does not apply to agreements for selling intangible property or for rendering personal services as, for example, agreements establishing insurance agencies or agencies for the brokerage of securities. Further, it applies to a distributorship agreement only if the distributor has made a substantial investment of capital in the distributorship. The substantial capital investment must be reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property. An investment is not considered substantial for purposes of section 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the goods distributed, or consists of a substantial inventory of such goods. The investment required in the maintenance of an office merely for clerical operations is not considered substantial for purposes of this section. Furthermore, section 1241 shall not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time before the cancellation of the distributorship agreement. It is immaterial for the purposes of section 1241 whether the distributor acquired the assets used in performing the functions of the distributorship before or after beginning his operations under the distributorship agreement. It is also immaterial whether the distributor is a retailer, wholesaler, jobber, or other type of distributor. The application of this paragraph may be illustrated by the following examples:

*Example (1).* Taxpayer is a distributor of various food products. He leases a warehouse including cold storage facilities and owns a number of motor trucks. In 1955 he obtains the exclusive rights to market certain frozen food products in his State. The marketing is accomplished by using the warehouse and trucks acquired before he entered into the agreement and entails no additional capital. Payments received upon the cancellation of the agreement are treated under section 1241 as though received upon the sale or exchange of the agreement.

*Example (2).* Assume that the taxpayer in example (1) entered into an exclusive distributorship agreement with the producer under which the taxpayer merely solicits orders through his staff of salesmen, the foods being shipped direct to the purchasers. Payments received upon the cancellation of the agreement would not be treated under section 1241 as though received upon the sale or exchange of the agreement.

*Example (3).* Taxpayer is an exclusive distributor for M city of certain frozen food products which he distributes to frozen-food freezer and locker customers. The terms of his distributorship do not make it necessary for him to have any substantial investment in inventory. Taxpayer rents a loading platform for a nominal amount, but has no warehouse space. Orders for goods from customers are consolidated by the taxpayer and forwarded to the producer from time to time. Upon receipt of these goods, taxpayer allocates them to the individual orders of customers and delivers them immediately by truck. Although it would require a fleet of fifteen or twenty trucks to carry out this operation, the distributor uses only one truck of his own and hires cartage companies to deliver the bulk of the merchandise to the customers. Payments received upon the cancellation of the distributorship agreement in such a case would not be considered received upon the sale or exchange of the agreement under section 1241 since the taxpayer does not have facilities for the physical handling of more than a small fraction of the goods involved in carrying on the distributorship and, therefore, does not have a substantial capital investment in the distributorship. On the other hand, if the taxpayer had acquired and used a substantial number of the trucks necessary for the deliveries to his customers, payments received upon the cancellation of the agreement would be considered received in exchange therefor under section 1241.

## READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

### WAR LOSS RECOVERIES

#### § 1.1335-1 ELECTIVE METHOD; TIME AND MANNER OF MAKING ELECTION AND EFFECT THEREOF.—\* \* \*

[Paragraph (b) of § 1.1335-1 as set forth in a previously issued pamphlet in this series (Publication No. 329-1, page 461) was deleted by T.D. 6230 and the following provisions inserted in lieu thereof.]

(b) *Manner of election.*—In all cases the election to have the provisions of section 1333 apply must be made by the taxpayer not later than six months from the last day prescribed by law for the filing of his income tax return for any taxable year in which a recovery of war loss property has occurred. The election shall be evidenced by a written statement, made within such 6-month period, that the taxpayer elects to have the provisions of section 1333 apply to any taxable year in which any money or property is recovered in respect of war loss property. The statement may be made in (or attached to)—

- (1) The return or amended return filed for such taxable year;
- (2) A claim for refund or credit filed for such taxable year for an overpayment resulting from application of such provisions;
- (3) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for any taxable year in which a recovery of war loss property occurred; or

(4) A letter addressed to the district director for the district in which the return for such taxable year was required to be filed.

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing), such election shall not be considered made until such last day. See section 7502 and the regulations thereunder with respect to the timeliness of filing an election where filing is done by mail and section 7503 and the regulations thereunder with respect to the timeliness of filing where the last day for filing falls on a Saturday, Sunday, or legal holiday.

[Paragraph 2 of T.D. 6230 provides that § 1.1335-1(b) as above set forth shall be effective as of April 25, 1957, the date of filing by the Division of the Federal Register. However, an election made under section 1335 shall be timely if made within 60 days of the effective date of amended paragraph (b) by any taxpayer who can establish to the satisfaction of the district director that as a result of reliance in good faith upon the provisions of § 1.1335-1(b), effective prior to the amendment set forth above, or corresponding provisions of regulations continued in effect by T.D. 6091, an election under section 1335 for a taxable year governed by the Internal Revenue Code of 1954 was postponed beyond the 6-month period provided by amended § 1.1335-1(b).]

#### CLAIM OF RIGHT

### § 1.1341 STATUTORY PROVISIONS; COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

#### SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

##### (a) GENERAL RULE.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds \$3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

For purposes of paragraph (5) (B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income),

##### (b) SPECIAL RULES.—

(1) If the decrease in tax ascertained under subsection (a) (5) (B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the



sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments made by a regulated public utility (as defined in section 1503(c) without regard to paragraph (2) thereof) if such refunds or repayments are required to be made by the government, political subdivision, agency, or instrumentality referred to in such section.

§ 1.1341-1 RESTORATION OF AMOUNTS RECEIVED OR ACCRUED UNDER CLAIM OF RIGHT.—(a) *In general.*—(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 to a deduction of more than \$3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 for the taxable year shall be the tax provided in paragraph (b).

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

(3) For purposes of determining whether the amount of a deduction described in section 1341(a)(2) exceeds \$3,000 for the taxable year, there shall be taken into account the aggregate of all such deductions with respect to each item of income (described in section 1341(a)(1)) of the same class.

(b) *Determination of tax.*—(1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax (under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 (other than subchapter E) of the Internal Revenue Code of 1939 or under the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (i) of this section where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(2) If the taxpayer computes his tax for the taxable year under the provisions of section 1341(a)(5) and subdivision (ii) of subparagraph (1) of this paragraph, the amount of the restoration shall not be taken into account in computing taxable income or loss for the tax-

§ 1.1341-1(a)(1)

able year, including the computation of any net operating loss carry-back or carryover or any capital loss carryover.

(3) If the tax determined under subparagraph (1) (i) of this paragraph is the same as the tax determined under subparagraph (1) (ii) of this paragraph, the tax imposed for the taxable year under chapter 1 shall be the tax determined under subparagraph (1) (i), and section 1341 and this section shall not otherwise apply.

(c) *Application to deductions which are capital in nature.*—Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores \$4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the \$3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

(d) *Determination of decrease in tax for prior taxable years.*—  
(1) *Prior taxable years.*—The prior taxable year (or years) referred to in paragraph (b) of this section is the year (or years) in which the item to which the deduction is attributable was included in gross income under a claim of right and, in addition, any other prior taxable year (or years) the tax for which will be affected by the exclusion from gross income in such prior taxable year (or years) of such income.

(2) *Amount of exclusion from gross income in prior taxable years.*—

(i) The amount to be excluded from gross income for the prior taxable year (or years) in determining the decrease in tax under section 1341(a) (5) (B) and paragraph (b) (1) (ii) of this section shall be the amount restored in the taxable year, but shall not exceed the amount included in gross income in the prior taxable year (or years) under the claim of right to which the deduction for the restoration is attributable, and shall be adjusted as provided in subdivision (ii) of this subparagraph.

(ii) If the amount included in gross income for the prior taxable year (or years) under the claim of right in question was reduced in such year (or years) by a deduction allowed under section 1202 (or section 117(b) of the Internal Revenue Code of 1939 or corresponding provisions of prior revenue laws), then the amount determined under subdivision (i) of this subparagraph to be excluded from gross income for such year (or years) shall be reduced in the same proportion that the amount included in gross income under a claim of right was reduced.

(iii) The determination of the amount of the exclusion from gross income of the prior taxable year shall be made without regard to the capital loss limitation contained in section 1211 applicable in computing taxable income for the current taxable year. The amount of the exclusion from gross income in a prior taxable year

(or years) shall not exceed the amount which would, but for the application of section 1211, be allowable as a deduction in the taxable year of restoration.

(iv) The rule provided in subdivision (iii) of this subparagraph may be illustrated as follows:

*Example.* For the taxable year 1952, an individual taxpayer had long-term capital gains of \$50,000 and long-term capital losses of \$10,000, a net long-term gain of \$40,000. He also had other income of \$5,000. In 1956, taxpayer restored the \$50,000 of long-term gain. He had no capital gains or losses in 1956 but had other income of \$5,000. If his tax liability for 1956, the taxable year of restoration, is computed by taking the deduction into account, the taxpayer would be entitled to a deduction under section 1211 of only \$1,000 on account of the capital loss. However, if the taxpayer computes his tax under section 1341(a) (5) and paragraph (b) (1) (ii) of this section, it is necessary to determine the decrease in tax for 1952. In such a determination, \$50,000 is to be excluded from gross income for that year, resulting in a net capital loss for that year of \$10,000, and a capital loss deduction of \$1,000 under section 117(d) of the 1939 Code (corresponding to section 1211 of the 1954 Code) with carryover privileges. The difference between the tax previously determined and the tax as recomputed after such exclusion for the years affected will be the amount of the decrease.

(3) *Determination of amount of deduction attributable to prior taxable years.*—

(i) If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be readily identified, then the portion attributable to each such prior taxable year shall be that proportion of the deduction otherwise allowable for the taxable year which the amount of income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

(ii) The rule provided in subdivision (i) of this subparagraph may be illustrated as follows:

*Example.* Under a claim of right, A included in his gross income over a period of three taxable years an aggregate of \$9,000 for services to a certain employer, in amounts as follows: \$2,000 for taxable year 1952, \$4,000 for taxable year 1953, and \$3,000 for taxable year 1954. In 1955 it is established that A must restore \$6,750 of these amounts to his employer, and that A is entitled to a deduction of this amount in the taxable year 1955. The amount of deduction attributable to each of the prior taxable years cannot be identified. Accordingly, the amount of the deduction attributable to each prior taxable year is:

$$\begin{aligned} 1952 &-\$6,750 \times \frac{\$2,000}{\$9,000} = \$1,500 \\ 1953 &-\$6,750 \times \frac{\$4,000}{\$9,000} = \$3,000 \\ 1954 &-\$6,750 \times \frac{\$3,000}{\$9,000} = \$2,250 \end{aligned}$$

(4) *Computation of amount of decrease in tax.*—

(i) In computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which approximately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction otherwise allowable in the taxable year is attributable.

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

(iii) The rules provided in this subparagraph may be illustrated as follows:

*Example (1)* For the taxable year 1954, a corporation had taxable income of \$35,000, on which it paid a tax of \$12,700. Included in gross income for the year was \$20,000 received under a claim of right as royalties. In 1957, the corporation is required to return \$10,000 of the royalties. It otherwise has taxable income in 1957 of \$5,000, so that without the application of section 1341 it has a net operating loss of \$5,000 in that year. Facts also come to light in 1957 which entitle the corporation to an additional deduction of \$5,000 for 1954. When a computation is made under § 1.1341-1(b) (1) (i), the corporation has no tax for the taxable year 1957. When a computation is made under § 1.1341-1(b) (1) (ii), the tax for 1957, without taking the restoration into account, is \$1,500, based on a taxable income of \$5,000. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954.....	\$12,700
Taxable income for 1954 upon which tax shown on return was based..	\$35,000
Less: Additional deduction (on account of which credit or refund could be made) .....	5,000
	<u>\$30,000</u>
Tax on \$30,000 (adjusted taxable income for 1954) .....	10,100
Tax on \$30,000 (adjusted taxable income for 1954) .....	<u>\$10,100</u>
Taxable income for 1954, as adjusted.....	\$30,000
Less exclusion of amount restored .....	10,000
	<u>\$20,000</u>
Taxable income for 1954 by applying § 1.1341-1(b) (1) (ii) ...	\$20,000
Tax on \$20,000 .....	6,000
Decrease in tax for 1954 by applying § 1.1341-1(b) (1) (ii) .....	\$4,100
Tax for 1957 without taking the restoration into account.....	1,500
Amount by which decrease exceeds the tax for 1957 computed without taking restoration into account.....	<u>\$2,600</u>

(The \$2,600 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has made an overpayment of \$2,600 (\$12,700 less \$10,100) for 1954 because of the additional deduction of \$5,000.)

*Example (2).* Assume the same facts as in example (1) except that, instead of the corporation being entitled to an additional deduction of \$5,000 for 1954, it is determined that the corporation failed to include an item of \$5,000 in gross income for that year. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954.....	\$12,700
Taxable income for 1954 upon which tax shown on return was based..	\$35,000
Plus: Additional income (on account of which deficiency assessment could be made) .....	5,000
Total .....	<u>\$40,000</u>
Tax on \$40,000 (adjusted taxable income for 1954) .....	15,300
Tax on \$40,000 (adjusted taxable income for 1954) .....	<u>\$15,300</u>
Taxable income for 1954 as adjusted.....	\$40,000
Less exclusion of amount restored.....	10,000
	<u>\$30,000</u>
Taxable income for 1954 by applying § 1.1341-1(b) (1) (ii) ....	\$30,000
Tax on \$30,000 .....	10,100
Decrease in tax for 1954 by applying § 1.1341-1(b) (1) (ii) .....	\$5,200
Tax for 1957 without taking the restoration into account.....	1,500
Amount by which decrease exceeds the tax for 1957 computed without taking the restoration into account.....	<u>\$3,700</u>

(The \$3,700 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has a deficiency of \$2,600 (\$15,300 less \$12,700) for 1954 because of the additional income of \$5,000.)

*Example (3).* For the taxable year 1954, a corporation had taxable income of \$25,000, on which it paid a tax of \$7,500. Included § 1.1341-1(d) (4) (iii)

in gross income for the year was \$10,000 received under a claim of right as commissions. In 1956, the corporation is required to return \$5,000 of the commissions. The corporation has a net operating loss of \$10,000 for 1956, excluding the deduction for the \$5,000 restored. When a computation is made under either § 1.1341-1(b) (1) (i) or § 1.1341-1(b) (1) (ii), the corporation has no tax for the taxable year 1956. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954.....	\$7,500
Taxable income for 1954 upon which tax shown on return was based..	\$25,000
Less: Additional deduction (on account of net operating loss carryback from 1956) .....	10,000
Net income as adjusted.....	\$15,000
Tax on \$15,000 (adjusted taxable income for 1954) .....	4,500
Tax on \$15,000 (adjusted taxable income for 1954) .....	\$4,500
Taxable income for 1954, as adjusted.....	\$15,000
Less: Exclusion of amount restored.....	5,000
Taxable income for 1954 by applying § 1.1341-1(b) (1) (ii) .....	\$10,000
Tax on \$10,000 .....	3,000
Decrease in tax for 1954 by applying § 1.1341-1(b) (1) (ii) .....	\$1,500
Tax for 1956 without taking the restoration into account.....	none
Amount by which decrease exceeds the tax for 1956 computed without taking the restoration into account.....	\$1,500

(The \$1,500 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1956 and is available as a refund. In addition, the taxpayer has an overpayment of \$3,000 (\$7,500 less \$4,500) for 1954 because of the net operating loss deduction of \$10,000.)

*Example (4).* For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of \$42,000, deductions amounting to \$12,000, and a net income of \$30,000. Gross income included among other items salary in the amount of \$15,000 and rental income in the amount of \$5,000. During the taxable year he donated \$10,000 to the American Red Cross and in his return claimed a deduction of \$6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23 (o) of the Internal Revenue Code of 1939 for the year 1946. In computing his net income he omitted interest income amounting to \$6,000 and neglected to take a deduction for interest paid in the amount of \$4,500. The return disclosed a tax liability of \$11,970, which was assessed and paid. In 1955, after the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946, the taxpayer had to restore the \$5,000 included in his gross income in 1946 as rental income. The amount of the decrease in tax for 1946 is \$2,467.62, computed as follows:

Tax previously determined for 1946.....	\$11,970.00
Net income for 1946 upon which tax previously determined was based .....	\$30,000.00
Less: Rents included under claim of right.....	5,000.00
Balance .....	\$25,000.00
Adjustment for contributions (add 15 percent of \$5,000) .....	750.00
Net income as adjusted.....	\$25,750.00
Tax on \$25,750.00 .....	9,502.38
Amount of decrease in tax for 1946:	
Tax previously determined .....	\$11,970.00
Tax as recomputed .....	9,502.38
Decrease in tax .....	\$2,467.62

The recomputation to determine the amount of the decrease in tax for 1946 does not take into consideration the barred item of \$6,000 representing interest received, which was omitted from gross income, or the barred item of \$4,500 representing interest paid for which no deduction was allowed. See subdivision (ii) of this subparagraph.

(e) *Method of accounting.*—The provisions of section 1341 and this section shall be applicable in the case of a taxpayer on the cash receipts and disbursements method of accounting only to the taxable year in which the item of income included in a prior year (or years) under a claim of right is actually repaid. However, in the case of a taxpayer on the cash receipts and disbursements method of accounting who constructively received an item of income under a claim of right and included such item of income in gross income in a prior year (or years), the provisions of section 1341 and this section shall be applicable to the taxable year in which the taxpayer is required to relinquish his right to receive such item of income. Such provisions shall be applicable in the case of other taxpayers only to the taxable year which is the proper taxable year (under the method of accounting used by the taxpayer in computing taxable income) for taking into account the deduction resulting from the restoration of the item of income included in a prior year (or years) under a claim of right. For example, if the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

(f) *Inventory items, stock in trade, and property held primarily for sale in the ordinary course of trade or business.*—

(1) Except for amounts specified in subparagraph (2) of this paragraph the provisions of section 1341 and this section do not apply to deductions attributable to items which were included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items.

(2) The provisions of section 1341 and this section apply to deductions  
§ 1.1341-1(e)

tions which arise out of refunds or repayments made by a regulated public utility, as defined in section 1503(c) (1) or (3) and § 1.1502-2 (g), if such refunds or repayments are required to be made by the government, political subdivision, agency, or instrumentality referred to in such section. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are eligible for the benefits of section 1341 and this section, if such refunds are required by the governmental authority.

(g) *Bad debts*.—The provisions of section 1341 and this section do not apply to deductions attributable to bad debts.

(h) *Legal fees and other expenses*.—Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income. This rule may be illustrated by the following example:

*Example.* A sold his personal residence to B in a prior taxable year and realized a capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A rejected C's demand and included the entire amount of the capital gain in gross income for the year of sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341(a) and § 1.1341-1(a).

(i) *Refunds*.—If the decrease in tax for the prior taxable year (or years) determined under section 1341(a) (5) (B) and paragraph (b) (1) (ii) of this section exceeds the tax imposed by chapter 1 for the taxable year computed without the deduction, the excess shall be considered to be a payment of tax for the taxable year of the deduction. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year.

## § 1.1342 STATUTORY PROVISIONS; COMPUTATION OF TAX WHERE TAXPAYER RECOVERS SUBSTANTIAL AMOUNT HELD BY ANOTHER UNDER CLAIM OF RIGHT.

### SEC. 1342. COMPUTATION OF TAX WHERE TAXPAYER RECOVERS SUBSTANTIAL AMOUNT HELD BY ANOTHER UNDER CLAIM OF RIGHT.

#### (a) GENERAL RULE.—If—

(1) an item was deducted from gross income for a prior taxable year (or years) because it appeared that another person held an unrestricted right to such item as a result of a court decision in a patent infringement suit (whether or not the taxpayer is a party to such suit); and

(2) gross income is increased for the taxable year because it was established after the close of such prior taxable year (or years) that such other person did not have an unrestricted right to such item or to a portion of such item because of the subsequent reversal of such



court decision on the ground that such decision was induced by fraud or undue influence; and

(3) the amount of such increase in gross income exceeds \$3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with the gross income so increased; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such increase in gross income, plus

(B) the increase in tax (including interest) under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the elimination of such item (or portion thereof) as a deduction from gross income for such prior taxable year (or years).

(b) **SPECIAL RULE.**—For purposes of subsection (a) (5) (B) interest shall be computed from the due date of the return for such prior taxable year to the due date of the return for the taxable year.

[Added to the Internal Revenue Code of 1954 by sec. 3 of P. L. 384, 84th Congress, effective for taxable years beginning after December 31, 1954.]

§ 1.1342-1 **COMPUTATION OF TAX WHERE TAXPAYER RECOVERS SUBSTANTIAL AMOUNT HELD BY ANOTHER UNDER CLAIM OF RIGHT; EFFECTIVE DATE.**—Section 1342 shall apply with respect to taxable years beginning after December 31, 1954.

#### OTHER LIMITATIONS

§ 1.1346 **STATUTORY PROVISIONS; RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES.**

##### SEC. 1346. RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES.

Income (excluding interest) attributable to the recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional, and in respect of which a deduction was allowed in a prior taxable year, may be excluded from gross income for the taxable year, and the deduction allowed in respect thereof in such prior taxable year treated as not having been allowable, if—

(1) the taxpayer elects in writing (at such time and in such manner as may be prescribed by regulations prescribed by the Secretary or his delegate) to treat such deduction as not having been allowable for prior taxable year, and

(2) the taxpayer consents in writing to the assessment, within such period as may be agreed on, of any deficiency resulting from such treatment, even though the statutory period for the assessment of any such deficiency had expired before the filing of such consent.

§ 1.1346-1 **RECOVERY OF UNCONSTITUTIONAL TAXES.**—(a) *In general.*—(1) A taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year may elect, as provided in paragraph (b) of this section, to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery. Any such exclusion of income is subject to the requirements of section 1346 and this section.

(2) If a taxpayer elects to receive the benefits of section 1346, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in a prior taxable year (or years). The taxpayer's return for the prior taxable year (or years) with respect to which the

§ 1.1342-1

statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any. (An election under section 1346 may be made only if the taxpayer consents in writing to such assessment. See paragraph (b) of this section.) No other adjustment will be allowed.

(3) If the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed against the taxpayer within the period agreed upon between the taxpayer and the district director with respect to the taxable year of the prior deduction, even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 1346 and this section to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 111.

(b) *Manner of making election.*—(1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to treat the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the assessment, in respect of the taxable year for which the deduction was allowed, of any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired before the filing of such consent.

(2) The term "recovery," as used in this section, includes not only refund or credit of taxes previously paid, but also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

## § 1.1347 STATUTORY PROVISIONS; CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITION OF PROPERTY.

### SEC. 1347. CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITION OF PROPERTY.

In the case of amount (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than 15 years, the tax imposed by section 1 attributable to such receipt shall not exceed 30 percent of the amount (other than interest) so received.

§ 1.1347-1 TAX ON CERTAIN AMOUNTS RECEIVED FROM THE UNITED STATES.—(a) In the case of an amount (other than interest) received from the United States by an individual under a claim involving acquisition of property and remaining unpaid for more than 15 years, the tax imposed by section 1 attributable to such amount shall not exceed 30 percent of the amount (other than interest) so received. For the purpose of section 1347 and this section, such amount shall not include any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment.

(b) To determine the application of section 1347 and this section to a particular amount, the taxpayer shall first compute the tax imposed by section 1 upon his entire taxable income, including the amount specified in paragraph (a) of this section, without regard to the limitation on tax provided in section 1347. The proportion of the tax, so computed, indicated by the ratio which the taxpayer's taxable income attributable to the amount specified in paragraph (a), computed as prescribed in paragraph (c) of this section, bears to his total taxable income, is the portion of the tax attributable to such amount. If this portion of the tax exceeds 30 percent of the amount specified in paragraph (a), that portion of the tax shall be reduced to 30 percent of such amount.

(c) In determining the portion of the taxable income attributable to any amount specified in paragraph (a), the taxpayer shall allocate to such amount received and to the gross income derived from all other sources, the expenses, losses, and other deductions properly attributable thereto, and shall apply any general expenses, losses, and other deductions (which cannot be properly apportioned otherwise) ratably to the gross income from all sources. The amount specified in paragraph (a), less the deductions properly attributable thereto and less its proportion of any general deductions, shall be the taxable income attributable to such amount. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses and deductions are allocated or apportioned.

#### WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND TAX FREE COVENANT BONDS

##### NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

#### § 1.1441 STATUTORY PROVISIONS; WITHHOLDING OF TAX ON NON-RESIDENT ALIENS. \* \* \*

[In § 1.1441, section 1441(c) as set forth in a previously issued pamphlet in this series (Publication No. 329-2, page 523) was amended by T.D. 6229 by adding a new paragraph (6) at the end thereof as set forth below.]

(6) PER DIEM OF CERTAIN ALIENS.—No deduction or withholding under subsection (a) shall be required in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended.

[T.D. 6229 also provides for the insertion of the following historical note at the end of section 1441.]

[Sec. 1441, I. R. C. 1954, as amended by sec. 54(f) of Mutual Security Act 1954 added by sec. 11(a), Mutual Security Act 1956.]

#### § 1.1347-1(a)

## § 1.1441-4 EXEMPTIONS FROM WITHHOLDING.—\* \* \*

[Section 1.1441-4 as set forth in a previously issued pamphlet in this series (Publication No. 329-2, page 529) was amended by T.D. 6229 by adding a new paragraph (e) at the end thereof as set forth below.]

(e) *Per diem of certain alien trainees.*—Effective with respect to payments made on and after July 18, 1956, withholding is not required under section 1441(a) or § 1.1441-1 in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended (22 U. S. C. ch. 24). This rule shall apply even though such amounts are subject to tax under section 871.

## \* \* \* § 1.1441-5 CLAIMING UNITED STATES CITIZENSHIP OR RESIDENCE.—\* \* \*

[Paragraph (c) of § 1.1441-5 as set forth in a previously issued pamphlet in this series (Publication 329-2, page 530) was deleted by T.D. 6238, effective with respect to payments made after December 31, 1956. Paragraphs (d), (e), and (f) thereof were redesignated as paragraphs (c), (d), and (e), respectively, and the following new sentence was added at the end of redesignated paragraph (c) thereof.]

Nothing in this section shall be construed, however, to require the renewal of a statement of citizenship or residence, or of a Form 1078, which was filed in accordance with prior regulations in effect at the time of the filing, if such statement or form has been actively and continuously used, since such time, as a basis for determining the United States citizenship or residence of the payee involved.

## RELATED ADMINISTRATIVE PROVISIONS

### DECLARATIONS OF ESTIMATED INCOME TAX

#### REQUIREMENTS

## § 1.6015(a) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; REQUIREMENT OF DECLARATION.

### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS.

(a) **REQUIREMENT OF DECLARATION.**—Every individual (other than a nonresident alien with respect to whose wages, as defined in section 3401(a), withholding under chapter 24 is not made applicable, but including every alien individual who is a resident of Puerto Rico during the entire taxable year) shall make a declaration of his estimated tax for the taxable year if—

(1) the gross income for the taxable year can reasonably be expected to consist of wages (as defined in section 3401(a)) and of not more than \$100 from sources other than such wages, and can reasonably be expected to exceed—

(A) \$5,000, in the case of a single individual other than a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)) or in the case of a married individual not entitled to file a joint declaration with his spouse;

(B) \$10,000, in the case of a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)); or

(C) \$5,000 in the case of a married individual entitled under subsection (b) to file a joint declaration with his spouse, and the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed \$10,000; or

(2) the gross income can reasonably be expected to include more than \$100 from sources other than wages (as defined in section 3401(a)) and can reasonably be expected to exceed the sum of—

## § 1.6015(a)

(A) the amount obtained by multiplying \$600 by the number of exemptions to which he is entitled under section 151 plus

(B) \$400.

§ 1.6015(a)-1 **DECLARATIONS OF ESTIMATED INCOME TAX BY INDIVIDUALS.**—(a) *Requirement.*—A declaration of estimated tax shall be made by every citizen of the United States, whether residing at home or abroad, every individual residing in the United States though not a citizen thereof, every nonresident alien who is a resident of Canada, Mexico, or Puerto Rico and who has wages subject to withholding at the source under section 3402, and every nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year, if—

(1) The gross income for the taxable year can reasonably be expected to consist of wages (as defined in section 3401 (a)) and of not more than \$100 from sources other than such wages, and can reasonably be expected to exceed—

(i) \$5,000, in the case of a single individual other than a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)) or in the case of a married individual not entitled to file a joint declaration with his spouse;

(ii) \$10,000, in the case of a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)); or

(iii) \$5,000, in the case of a married individual entitled under section 6015(b) to file a joint declaration with his spouse, and the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed \$10,000; or

(2) The gross income can reasonably be expected to include more than \$100 from sources other than wages (as defined in section 3401 (a)) and can reasonably be expected to exceed the sum of—

(i) The amount obtained by multiplying \$600 by the number of exemptions to which he is entitled under section 151 plus

(ii) \$400.

(b) *Income of child.*—In estimating his gross income for the taxable year a part should not take into account the income of his minor child. Such income is not includible in the gross income of the parent. See section 73 and § 1.73-1.

(c) *Exemption of spouse.*—For the purpose of determining whether a declaration of estimated tax is required under the provisions of paragraph (a)(2) of this section, a married person filing a separate declaration may not take into account the exemption of his spouse, if his spouse has, or is reasonably expected to have, gross income, or is reasonably expected to be the dependent of another taxpayer, for the taxable year.

(d) *Nonresident aliens.*—(1) A nonresident alien who is—

(i) A resident of Canada or Mexico and enters and leaves the United States at frequent intervals, or

(ii) A resident of Puerto Rico, and who has wages subject to withholding under section 3402, is required to file a declaration of estimated tax if his gross income meets the requirements of section 6015(a). In the case of a nonresident alien (other than an alien resident of Puerto Rico for the

entire taxable year) gross income means only gross income from sources within the United States. See sections 872 and 876 and the regulations thereunder. As to what constitutes gross income from sources within the United States, see sections 861 to 864, inclusive, and the regulations thereunder. Thus, for example, a nonresident alien, living in Mexico with his wife throughout 1955, makes his return on a calendar year basis. His wife is also a nonresident alien. He is employed as an executive in El Paso, Texas, at a salary of \$8,000 per annum and enters and leaves the United States at frequent intervals in pursuit of such employment. He has no reasonable expectation of any other income from United States sources. Since the gross income of such individual derived from sources within the United States in 1955 can reasonably be expected to amount to more than \$5,000 (married individual not entitled to file a joint declaration with his spouse), a declaration of estimated tax must be made by such resident of Mexico for 1955.

(2) A nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year is required to file a declaration of estimated tax if his gross income meets the requirements of section 6015(a). For the purpose of such declaration, gross income means gross income from all sources, other than sources within Puerto Rico (but including amounts received for services performed within Puerto Rico as an employee of the United States or any agency thereof). See sections 876 and 933 and the regulations thereunder.

(e) *Examples.*—The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* H maintains as his home a household which is the principal place of abode of himself and his two dependent children. H's wife died in 1953 and he had not remarried. H and his wife filed a joint return for 1953. H's salary from January 1 to June 30, 1955, is at the annual rate of \$9,000. However, effective July 1, 1955, his annual salary is increased to \$12,000, and under the facts then existing it is reasonable to assume that his salary for the remaining portion of 1955 will remain unchanged and that his total salary for the year will, therefore, be \$10,500. Since H is a surviving spouse (as defined in section 2(b)) and his gross income can reasonably be expected to exceed \$10,000, he is required to file a declaration of estimated tax for 1955. As to when such declaration must be filed, see section 6073 and §§ 1.6073-1 to 1.6073-4, inclusive.

*Example (2).* P, a taxpayer making his return on the calendar year basis, is married and has two dependent children. Neither his wife nor his children have any source of income. P is engaged in the practice of his profession on his own account and has gross income of \$600 from such profession for the two months of January and February 1955. He reasonably expects that his gross income from his profession will continue to average \$300 each month throughout the year and that he will have on income from any other source during 1955. Since P has gross income which can for 1955 reasonably be expected to exceed \$2,800 (\$2,400 for four exemptions plus \$400), and such income does not constitute wages subject to withholding, he is required to file a declaration of estimated tax for that year.

*Example (3).* S, a married taxpayer, has been regularly em-

ployed for many years prior to January 1, 1955, at which date his weekly wage is \$75. Neither his wife nor his two children have any source of income. S also owns stock in a corporation from which he has derived regularly for many years prior to 1955, annual dividends ranging from \$150 to \$175. In view of the fact that his gross income can reasonably be expected to include more than \$100 from sources other than wages, and can reasonably be expected to exceed \$600 multiplied by his four personal exemptions plus \$400, or \$2,800, S is required to make a declaration of estimated tax for 1955.

*Example (4).* H and W, husband and wife, derive their income from wages. Their joint savings account nets them less than \$50 in interest each year. During 1955, H expects to receive wages of \$7,500, and W expects to receive wages of \$4,500. A declaration is required for 1955 since the aggregate gross income of H and W can be expected to exceed \$10,000. In the event H and W do not file a joint declaration, a separate declaration must be filed by H since his gross income can reasonably be expected to exceed \$5,000 and the aggregate gross income of H and W can reasonably be expected to exceed \$10,000.

(f) *Declarations made by agents.*—The declaration may be made by an agent if, by reason of illness, the person liable for the making of the declaration is unable to make it. The declaration may also be made by an agent if the taxpayer is unable to make the declaration by reason of continuous absence from the United States (including Puerto Rico as if a part of the United States) for a period of at least 60 days prior to the date prescribed by law for making the declaration. Whenever a declaration is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsiding general power of attorney authorizing him to represent his principal in making, executing, and filing the declaration, may submit a certified copy thereof in lieu of the authorization on Form 935. The taxpayer and his agent, if any, are responsible for the declaration as made and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

## § 1.6015(b) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; JOINT DECLARATION BY HUSBAND AND WIFE.

### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(b) *JOINT DECLARATION BY HUSBAND AND WIFE.*—In the case of a husband and wife, a single declaration under this section may be made by them jointly, in which case the liability with respect to the estimated tax shall be joint and several. No joint declaration may be made if either the husband or the wife is a nonresident alien, if they are separated under a decree of divorce or of separate maintenance, or if they have different taxable years. If a joint declaration is made but a joint return is not made for the taxable year, the estimated tax for such year may be treated as the estimated tax of either the husband or the wife, or may be divided between them.

§ 1.6015(b)–1 *JOINT DECLARATION BY HUSBAND AND WIFE.*—(a) *In general.*—A husband and wife may make a joint declaration of estimated tax even though they are not living together. However,

§ 1.6015(a)–1(f).

a joint declaration may not be made if they are separated under a decree of divorce or of separate maintenance. A joint declaration may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico during the entire taxable year) or if his spouse has a different taxable year. If the gross income of each spouse meets the requirements of section 6015(a), either a joint declaration must be made or a separate declaration must be made by each. For computation of tax in case of a joint return, see § 1.2-1. If a joint declaration is made by husband and wife, the liability with respect to the estimated tax shall be joint and several.

(b) *Application to separate returns.*—The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in such manner as they may agree. In the event the husband and wife fail to agree to a division, such payments shall be allocated between them in accordance with the following rule. The portion of such payments to be allocated to a spouse shall be that portion of the aggregate of all such payments as the amount of tax shown on the separate return of the taxpayer bears to the sum of the taxes shown on the separate returns of the taxpayer and his spouse.

(c) *Death of spouse.*—(1) A joint declaration may not be made after the death of either the husband or wife. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for his taxable year and the last taxable year of the deceased spouse he may, in making a separate declaration for his taxable year which includes the period comprising such last taxable year of his spouse, estimate taxable income on an aggregate basis and compute his estimated tax in the same manner as though a joint declaration has been filed.

(2) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of any subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is made by such spouse. Such separate estimated tax shall be paid at the times and in the amounts determined under the rules prescribed in section 6153. For the purpose of (i) such amended declaration by the surviving spouse, and (ii) allocating the payments made pursuant to the joint declaration between the surviving spouse and the legal representative of the decedent in the event a joint return is not filed, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree. In the event the surviving spouse and the legal representative of the decedent fail to agree to a division, such payments shall be allocated in accordance with the following rule.



The portion of such payments to be allocated to the surviving spouse shall be that portion of the aggregate amount of such payments as the amount of tax shown on the separate return of the surviving spouse bears to the sum of the taxes shown on the separate returns of the surviving spouse and of the decedent, and the balance of such payments shall be allocated to the decedent.

(d) *Signing of declaration.*—A joint declaration of a husband and wife shall be signed by both spouses or, if signed by one spouse as agent for the other, authorization must accompany the declaration. Both spouses, whether or not one acts as agent for the other, are responsible for making the declaration and incur liability for the penalties provided for erroneous, false, or fraudulent declarations. For provisions relating to the making of declarations by agents, see § 1.6015 (a)–1 (f).

### § 1.6015(c) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; ESTIMATED TAX.

#### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(c) *ESTIMATED TAX.*—For purposes of this title, in the case of an individual, the term “estimated tax” means the amount which the individual estimates as the amount of the income tax imposed by chapter 1 for the taxable year, minus the amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

§ 1.6015(c)–1 *DEFINITION OF ESTIMATED TAX.*—In the case of an individual, the term “estimated tax” means the amount which the individual estimates as the amount of the income tax imposed by chapter 1 of the Code for the taxable year, minus the amount which he estimates as the sum of the credits against tax provided by part IV of subchapter A of such chapter. These credits are those provided by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to foreign taxes), section 34 (relating to dividends received), section 35 (relating to partially tax-exempt interest), and section 37 (relating to retirement income). An individual who expects to elect to pay the optional tax imposed by section 3, or one who expects to elect to take the standard deduction allowed by section 144, should disregard any credits otherwise allowable under sections 32, 33, and 35 in computing his estimated tax since, if he so elects, these credits are not allowed in computing his tax liability. See section 36.

#### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(d) *CONTENTS OF DECLARATION.*—The declaration shall contain such pertinent information as the Secretary or his delegate may by forms or regulations prescribe.

### § 1.6015(d) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; CONTENTS OF DECLARATION.

§ 1.6015(d)–1 *CONTENTS OF DECLARATION OF ESTIMATED TAX.*—

(a) *In general.*—(1) The declaration of estimated tax by an individual shall be made on Form 1040-ES. For the purpose of making

#### § 1.6015(b)–1(d)

the declaration, the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, depending upon the method of accounting upon which taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of estimated tax shall be determined upon the basis of the facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year. If, therefore, the taxpayer is employed at the date prescribed for filing his declaration at a given wage or salary, it should, in the absence of circumstances indicating the contrary, be presumed by him for the purpose of the declaration that such employment will continue to the end of the taxable year at the wage or salary received by him as of such date. In the case of income other than wages and salary the regularity in the payment of income, such as dividends, interest, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in a corporation and dividends have been paid regularly for several years upon such stock, the taxpayer in the preparation of his declaration should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the corporation for the taxable year as well as those actually received in such year prior to the filing of the declaration. In the case of a taxpayer engaged in business on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(2) In the case of any individual who can, at the time of the preparation of his declaration, reasonably anticipate that his gross income will be of such amount and character as to enable him to elect upon his return for such year to compute the tax under section 3 (relating to optional tax), in lieu of the tax imposed by section 1, the declaration of estimated tax may be made upon the basis set forth in section 3 and § 1.3-1. The filing of a declaration computed upon the basis of section 3 shall not constitute the making of an election under section 4 (relating to rules for optional tax) nor will it permit the filing of a return on the basis of the optional tax under section 3 unless the taxpayer otherwise comes within the provisions of sections 3 and 4. For the purpose of computing the tax liability in the case of married persons, if the taxable income of one spouse is determined without regard to the standard deduction, the standard deduction is not allowed to either. (See, however, § 1.142-1(c) for exceptions where spouses are legally separated under a decree of divorce or separate maintenance.) Hence, where separate declarations are filed, one spouse should not use section 3 in computing the estimated tax unless the other spouse also uses section 3 or employs the standard deduction in computing the estimated tax.

(b) *Computation of estimated tax.*—In computing the estimated tax there shall be shown on the declaration—

(1) The amount estimated as the tax for the taxable year after the application of any amounts estimated as the credit for foreign taxes, the dividends received credit, the retirement income credit,

the credit for partially tax-exempt interest, and the credit for tax withheld at source, but without regard to the credit under section 31 for tax withheld on wages;

(2) The amount estimated by the taxpayer as the credit under section 31 for tax withheld on wages; and

(3) The excess, if any, of the amount shown under subparagraph (1) of this paragraph over the amount shown under subparagraph (2) of this paragraph, which excess shall be the estimated tax for such taxable year.

If the taxpayer so desires, he may include in his declaration an amount estimated as the tax on self-employment income imposed by section 1401.

(c) *Use of prescribed form.*—Copies of Form 1040-ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished to him. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available, a statement disclosing the amount estimated as the tax, the estimated credits, and the estimated tax after deducting such credits should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

#### § 1.6015(e) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; AMENDMENT OF DECLARATION.

##### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(e) *AMENDMENT OF DECLARATION.*—An individual may make amendments of a declaration filed during the taxable year under regulations prescribed by the Secretary or his delegate.

§ 1.6015(e)-1 *AMENDMENT OF DECLARATION.*—In the making of a declaration of estimated tax, the taxpayer is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of exemptions to which the taxpayer may be entitled for the then current taxable year. However, only one amended declaration may be filed during any interval between installment dates. See § 1.6073-1(d). An amended declaration may be filed jointly by husband and wife even though separate declarations have previously been filed. An amended declaration may be made on either Form 1040-ES (marked "Amended") or on the reverse side of the Statement of Account or Notice of Payment Due furnished the taxpayer by the district director. See, however,

#### § 1.6015(d)-1(c)

Paragraph (c) of § 1.6015(d)-1 for procedure to be followed if the prescribed form is not available.

**§ 1.6015(f) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; RETURN AS DECLARATION OR AMENDMENT.**

**SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \***

(f) RETURN AS DECLARATION OR AMENDMENT.—If on or before January 31 (or February 15, in the case of an individual referred to in section 6073(b), relating to income from farming) of the succeeding taxable year the taxpayer files a return, for the taxable year for which the declaration is required, and pays in full the amount computed on the return as payable, then, under regulations prescribed by the Secretary or his delegate—

(1) if the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15, such return shall be considered as such declaration; and

(2) if the tax shown on the return (reduced by the sum of the credits against tax provided by part IV of subchapter A of chapter 1) is greater than the estimated tax shown in a declaration previously made, or in the last amendment thereof, such return shall be considered as the amendment of the declaration permitted by subsection (e) to be filed on or before January 15.

**§ 1.6015(f)-1 RETURN AS DECLARATION OR AMENDMENT.—(a) *Time for filing return.***—(1) If the taxpayer files his return for the calendar year on or before January 31 (or February 15, in the case of an individual referred to in section 6073(b), relating to income from farming) of the succeeding calendar year (or if the taxpayer is on a fiscal year basis, on or before the last day of the first month (in the case of a farmer, the 15th day of the second month) immediately succeeding the close of such fiscal year), and pays in full the amount computed on the return as payable, then—

(i) If the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year), such return shall be considered as such declaration; or

(ii) If a declaration was filed during the taxable year, such return shall be considered as the amendment of the declaration permitted by section 6015(e) to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year).

Hence, for example, an individual taxpayer on the calendar year basis who, subsequent to September 1, 1955, first meets the requirements of section 6015(a) which necessitate the filing of a declaration for 1955, may satisfy the requirements as to the filing of such declaration by filing his return for 1955 on or before January 31, 1956 (February 15, 1956, in the case of a farmer), and paying in full at the time of such filing the tax shown thereon to be payable. Likewise, if a taxpayer files on or before September 15, 1955, a timely declaration for such year and subsequent thereto and on or before January 31, 1956, files his return for 1955, and pays at the time of such filing the tax shown by the return to be payable, such return shall be treated as an amended declaration timely filed.

(2) For the purpose of section 6015(f) a taxpayer may file his

**§ 1.6015(f)-1(a)(2)**

return on or before the last day of the first month following the close of the taxable year even though he has not been furnished Form W-2 by him employer. In such case the taxpayer shall compute, as accurately as possible, his wages for such year and the tax withheld for which he is entitled to a credit, reporting such wages and tax on his return, together with all other pertinent information necessary to the determination of his tax liability for such year.

(b) *Effect on addition to the tax.*—Compliance with the provisions of section 6015(f) will enable a taxpayer to avoid the addition to the tax imposed by section 6654 with respect to an underpayment of the installment not required to be paid until January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). With respect to an underpayment of any earlier installment, compliance with section 6015(f) will not relieve the taxpayer from the addition to the tax imposed by section 6654. However, the period of the underpayment under section 6654(c), with respect to any earlier installment, will terminate on January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). For example, a taxpayer discovers on January 14, 1956, that he has underpaid his estimated tax for the calendar year 1955. He may, in lieu of filing an amended declaration on January 15, 1956, and paying the balance of the estimated tax determined thereon, file his final return on January 31, 1956, and pay in full the amount computed thereon as payable. By so doing, he will avoid the addition to the tax with respect to the underpayment of the installment required to be paid by January 15, 1956. The periods of underpayment, under section 6654(c), as to the installments required to be paid on April 15, 1955, June 15, 1955, and September 15, 1955, also terminate on January 15, 1956.

### § 1.6015(g) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; SHORT TAXABLE YEARS.

#### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(g) *SHORT TAXABLE YEARS.*—An individual with a taxable year of less than 12 months shall make a declaration in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.6015(g)-1 *SHORT TAXABLE YEARS OF INDIVIDUALS.*—(a) *Requirement of declaration.*—No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 53 weeks, in the case of a taxpayer who computes his taxable income in accordance with the election permitted by section 441(f) shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such a taxpayer, see § 1.441-2(b). A separate declaration for a fractional part of a year is required where, for example, there is a change, with the approval of the Commissioner, in the basis of computing taxable income from one taxable year to another taxable year. The periods to be covered by such separate declarations in the several cases are those set forth in section 443. No declaration is required if the short taxable year is—

(1) A period of less than four months,

#### § 1.6015(f)-1(b)

(2) A period of at least four months but less than six months and the requirements of section 6015(a) are first met after the 1st day of the fourth month,

(3) A period of at least six months but less than nine months and the requirements of section 6015(a) are first met after the 1st day of the sixth month, or

(4) A period of nine months or more and the requirements of section 6015(a) are first met after the 1st day of the ninth month. In the case of a decedent, no declaration need be filed subsequent to the date of death. As to the requirement for an amended declaration if death of one spouse occurs after filing a joint declaration, see § 1.6015(b)-1(c).

(b) *Income placed on annual basis.*—For the purpose of determining whether the anticipated income for a short taxable year, resulting from a change of annual accounting period, necessitates the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 443(b)(1). Thus, for example, a taxpayer who changes from a calendar year basis to a fiscal year basis beginning July 1, 1955, will have a short taxable year beginning January 1, 1955, and ending June 30, 1955. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 3401(a)) in the amount of \$3,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is \$6,000, the amount obtained by placing anticipated income of \$3,000 upon an annual basis. Hence, assuming such taxpayer is single, and is not a head of a household or a surviving spouse, he is required to file a declaration of estimated tax for the short taxable year since his anticipated gross income from wages when placed upon an annual basis is in excess of \$5,000.

## § 1.6015(h) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; ESTATES AND TRUSTS.

### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(h) ESTATES AND TRUSTS.—The provisions of this section shall not apply to an estate or trust.

§ 1.6015(h)-1 ESTATE AND TRUSTS.—An estate or trust, though generally taxed as an individual, is not required to file a declaration.

## § 1.6015(i) STATUTORY PROVISIONS; DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS; APPLICABILITY.

### SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS. \* \* \*

(i) APPLICABILITY.—This section shall be applicable only with respect to taxable year beginning after December 31, 1954; and sections 58, 59, and 60 of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6015(i)-1 APPLICABILITY.—Section 6015 is applicable only with respect to taxable years beginning after December 31, 1954. Sections 58, 59, and 60 of the Internal Revenue Code of 1939 and the regulations thereunder, shall continue in force with respect to taxable years beginning before January 1, 1955.

# § 1.6016 STATUTORY PROVISIONS; DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.

## SEC. 6016. DECLARATION OF ESTIMATED INCOME TAX BY CORPORATIONS.

(a) **REQUIREMENT OF DECLARATION.**—Every corporation subject to taxation under section 11 or 1201(a), or subchapter L of chapter 1 (relating to insurance companies), shall make a declaration of estimated tax under chapter 1 for the taxable year if its income tax imposed by section 11 or 1201(a), or such subchapter L, for such taxable year, reduced by the credits against tax provided by part IV of subchapter A of chapter 1, can reasonably be expected to exceed \$100,000.

(b) **ESTIMATED TAX.**—For purposes of this title, in the case of a corporation, the term “estimated tax” means the excess of—

(1) the amount which the corporation estimates as the amount of the income tax imposed by section 11 or 1201(a), or subchapter L of chapter 1, whichever is applicable, over

(2) the sum of—

(A) \$100,000, and

(B) the amount which the corporation estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

(c) **CONTENTS OF DECLARATION.**—The declaration shall contain such pertinent information as the Secretary or his delegate may by forms or regulations prescribe.

(d) **AMENDMENT OF DECLARATION.**—A corporation may make amendments of a declaration filed during the taxable year under regulations prescribed by the Secretary or his delegate.

(e) **SHORT TAXABLE YEAR.**—A corporation with a taxable year of less than 12 months shall make a declaration in accordance with regulations prescribed by the Secretary or his delegate.

(f) **APPLICABILITY.**—This section shall apply only with respect to taxable years ending on or after December 31, 1955.

§ 1.6016-1 **DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.**—(a) *Requirement.*—For taxable years ending on or after December 31, 1955, a declaration of estimated tax shall be made by every corporation (including unincorporated business enterprises electing to be taxed as domestic corporations under section 1361), which is subject to taxation under section 11 or 1201(a), or subchapter L of chapter 1 of the Code (relating to insurance companies), if its income tax under such sections or such subchapter L for the taxable year can reasonably be expected to exceed the sum of \$100,000 plus the amount of any estimated credits allowable under section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds) and section 33 (relating to taxes of foreign countries and possessions of the United States).

(b) *Definition of estimated tax.*—The term “estimated tax”, in the case of a corporation, means the excess of the amount which such corporation estimates as its income tax liability for the taxable year under section 11 or 1201(a), or subchapter L of chapter 1 of the Code over the sum of \$100,000 and any estimated credits under sections 32 and 33.

(c) *Examples.*—The application of this section may be illustrated by the following examples:

*Example (1).* C, a corporation subject to tax under section 11, reasonably anticipates that it will have taxable income of \$212,500 for the calendar year 1955. The normal tax and surtax result in an expected liability of \$105,000. C determines that it will not have

any allowable credits under sections 32 and 33 for 1955. Since C's expected tax (\$105,000) exceeds the exemption (\$100,000), a declaration of estimated tax is required to be filed, reporting an estimated tax of \$5,000 (\$105,000-\$100,000) for the calendar year 1955.

*Example (2).* Under the facts stated in example (1), except that C estimates it will have an allowable foreign tax credit under section 33 in the amount of \$10,000, no declaration is required, since C's expected tax (\$105,000) does not exceed the \$100,000 exemption plus the allowable credit of \$10,000.

§ 1.6016-2 CONTENTS OF DECLARATION OF ESTIMATED TAX.—(a) *In general.*—The declaration of estimated tax by a corporation shall be made on Form 1120-ES. For the purpose of making the declaration, the estimated tax should be based upon the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, as the case may be, depending upon the method of accounting upon the basis of which the taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account. Such amounts of gross income, deductions, and credits should be determined upon the basis of facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year.

(b) *Use of prescribed form.*—Copies of Form 1120-ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available a statement disclosing the estimated income tax after the exemption and the credits, if any, should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

§ 1.6016-3 AMENDMENT OF DECLARATION.—In the making of a declaration of estimated tax the corporation is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the corporation estimates that its gross income, deductions, or credits will materially change the estimated tax reported in the previous declaration. Such amended declaration may be made on either Form 1120-ES (marked "Amended") or on the reverse side of the Notice of Final Installment furnished the corporation by the district director. See, however, paragraph (b) of § 1.6016-2 for procedure to be followed if the prescribed form is not available.

§ 1.6016-4 SHORT TAXABLE YEAR.—(a) *Requirement of declaration.*—No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 63



weeks, in the case of a corporation which computes its taxable income in accordance with the election permitted by section 441(f) shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such corporation, see § 1.441-2(b). A separate declaration is required where a corporation is required to submit an income tax return for a period of less than 12 months, but only if such short period ends on or after December 31, 1955. However, no declaration is required if the short taxable year is—

(1) A period of less than 9 months, or

(2) A period of 9 or more months but less than 12 months and the requirements of section 6016(a) are not met before the 1st day of the last month in the short taxable year.

(b) *Income placed on an annual basis.*—In cases where the short taxable year results from a change of annual accounting period, for the purpose of determining whether the anticipated income for a short taxable year will result in an estimated tax liability requiring the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 443(b)(1). If a tax computed on such annualized income exceeds the sum of \$100,000 and any credits under part IV of subchapter A of chapter 1 of the Code, the estimated tax shall be the same part of the excess so computed as the number of months in the short period is of 12 months. Thus, for example, a corporation which changes from a calendar year basis to a fiscal year basis beginning October 1, 1956, will have a short taxable year beginning January 1, 1956, and ending September 30, 1956. If on or before August 31, 1956, the taxpayer anticipates that it will have income of \$264,000 for the 9-month taxable year the estimated tax is computed as follows:

(1) Anticipated taxable income for 9 months.....	\$264,000.00
(2) Annualized income ( $\$264,000 \times 12 \div 9$ ).....	352,000.00
(3) Tax liability on item (2).....	177,540.00
(4) Item (3) reduced by \$100,000 (there are no credits under part IV, subchapter A, chapter 1).....	77,540.00
(5) Estimated tax for 9-month period ( $\$77,540 \times 9 \div 12$ ).....	58,155.00

Since the tax liability on the annualized income is in excess of \$100,000, a declaration is required to be filed, reporting an estimated tax of \$58,155 for the 9-month taxable period. This paragraph has no application where the short taxable year does not result from a change in the taxpayer's annual accounting period.

#### TIME AND PLACE FOR FILING DECLARATIONS

#### § 1.6073 STATUTORY PROVISIONS; TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY INDIVIDUALS.

##### SEC. 6073. TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY INDIVIDUALS.

(a) *INDIVIDUALS OTHER THAN FARMERS.*—Declarations of estimated tax required by section 6015 from individuals not regarded as farmers for the purpose of that section shall be filed on or before April 15 of the taxable year, except that if the requirements of section 6015 are first met—

(1) After April 1 and before June 2 of the taxable year, the declaration shall be filed on or before June 15 of the taxable year, or

#### § 1.6016-4(b)

(2) After June 1 and before September 2 of the taxable year, the declaration shall be filed on or before September 15 of the taxable year, or

(3) After September 1 of the taxable year, the declaration shall be filed on or before January 15 of the succeeding year.

(b) **FARMERS.**—Declarations of estimated tax required by section 6015 from individuals whose estimated gross income from farming (including oyster farming) for the taxable year is at least two-thirds of the total estimated gross income from all sources for the taxable year may, in lieu of the time prescribed in subsection (a), be filed at any time on or before January 15 of the succeeding taxable year.

(c) **AMENDMENT.**—An amendment of a declaration may be filed in any interval between installment dates prescribed for that taxable year, but only one amendment may be filed in each such interval.

(d) **SHORT TAXABLE YEARS.**—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) **FISCAL YEARS.**—In the application of this section to the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

§ 1.6073-1 **TIME AND PLACE FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY INDIVIDUALS.**—(a) *Individuals other than farmers.*—Declarations of estimated tax for the calendar year shall be made on or before April 15th of such calendar year by every individual whose anticipated income for the year meets the requirements of section 6015 (a). If, however, the requirements necessitating the filing of the declaration are first met, in the case of an individual on the calendar year basis, after April 1st, but before June 2d of the calendar year, the declaration must be filed on or before June 15th; if such requirements are first met after June 1st and before September 2d, the declaration must be filed on or before September 15th; and if such requirements are first met after September 1st, the declaration must be filed on or before January 15th of the succeeding calendar year. In the case of an individual on the fiscal year basis, see § 1.6073-2.

(b) *Farmers.*—In the case of an individual on a calendar year basis, whose estimated gross income from farming (including oyster farming) for the calendar year is at least two-thirds of his total estimated gross income from all sources for such year, his declaration may be filed on or before the 15th day of January of the succeeding calendar year in lieu of the time prescribed in paragraph (a) of this section. For the filing of a return in lieu of a declaration, see § 1.6015 (f)-1 (a). The estimated gross income from farming (including oyster farming) is the estimated income resulting from the cultivation of the soil and the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. If an individual receives for the use of his land income in the form of a share of the crops produced thereon such income is from farming. As to determination of income of farmers, see sections 61 and 162 and the regulations thereunder.

(c) *Place for filing declaration.*—The declaration of estimated tax shall be filed with the district director for the district in which the taxpayer expects to file his income tax return.

§ 1.6073-1(c)

(d) *Amendment of declaration.*—An amended declaration of estimated tax may be filed during any interval between installment dates prescribed for the taxable year. However, no amended declaration may be filed until after the installment date on or before which the original declaration was filed and only one amended declaration may be filed during each interval between installment dates. An amended declaration shall be filed with the district director with whom the original declaration was filed.

§ 1.6073-2 FISCAL YEARS.—(a) *Individuals other than farmers.*—In the case of an individual on the fiscal year basis, the declaration must be filed on or before the 15th day of the 4th month of the taxable year. If, however, the requirements of section 6015(a) are first met after the 1st day of the 4th month and before the 2nd day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month of the taxable year. If such requirements are first met after the 1st day of the 6th month, and before the 2nd day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month of the taxable year. If such requirements are first met after the 1st day of the 4th month but before the 2d day of the 6th or before the 15th day of the 1st month of the succeeding fiscal year. Thus, if an individual taxpayer has a fiscal year ending on June 30, 1956, his declaration must be filed on or before October 15, 1955, if the requirements of section 6015(a) are met on or before October 1, 1955. If, however, such requirements are not met until after October 1, 1955, and before December 2, 1955, the declaration need not be filed until December 15, 1955.

(b) *Farmers.*—An individual on the fiscal year basis whose estimated gross income from farming (as defined in § 1.6073-1(b)) is at least two-thirds of his total estimated gross income from all sources for such taxable year may file his declaration on or before the 15th day of the month immediately following the close of his taxable year.

§ 1.6073-3 SHORT TAXABLE YEARS.—(a) *Individuals other than farmers.*—In the case of short taxable years the declaration shall be filed on or before the 15th day of the 4th month of such taxable year if the requirements of section 6015(a) are met on or before the 1st day of the 4th month of such year. If such requirements are first met after the 1st day of the 4th month but before the 2d day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month. If such requirements are first met after the 1st day of the 6th month but before the 2d day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month. If, however, the period for which the declaration is filed in one of 4 months, or one of 6 months and the requirements of section 6015(a) are not met until after the 1st day of the 4th month, or one of 9 months and such requirements are not met until after the 1st day of the 6th month, the declaration may be filed on or before the 15th day of the succeeding taxable year.

(b) *Farmers.*—In the case of an individual whose estimated gross income from farming (as defined in § 1.6073-1(b)) for a short taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed

on or before the 15th day of the month immediately following the close of such taxable year.

§ 1.6073-4 **EXTENSION OF TIME FOR FILING DECLARATIONS BY INDIVIDUALS.**—(a) *In general.*—District directors are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. An application for an extension of time for filing such a declaration shall be addressed to the district director for the district in which the taxpayer is required to file his declaration, and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing declarations may be granted for more than six months.

(b) *Citizens outside of the United States.*—In the case of a United States citizen outside the continental United States, Hawaii, and Puerto Rico on the 15th day of the 4th month of his taxable year, an extension of time for filing his declaration of estimated tax otherwise due on or before the 15th day of the 4th month of the taxable year is granted to and including the 15th day of the 6th month of the taxable year. As used in this paragraph, the term "continental United States" does not include the Territory of Alaska.

(c) *Addition to tax applicable.*—An extension of time for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654(c) without regard to such extension.

## § 1.6074 **STATUTORY PROVISIONS; TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.**

### SEC. 6074. **TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.**

(a) **GENERAL RULE.**—The declaration of estimated tax required of corporations by section 6016 shall be filed on or before the 15th day of the 9th month of the taxable year, except that if the requirements of section 6016 are first met after the last day of the 8th month and before the 1st day of the 12th month of the taxable year, the declaration shall be filed on or before the 15th day of the 12th month of the taxable year.

(b) **AMENDMENT.**—If a declaration is filed before the 15th days of the 12th month of the taxable year, an amendment of such declaration may be filed on or before such day.

(c) **SHORT TAXABLE YEAR.**—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.6074-1 **TIME AND PLACE FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.**—(a) *In general.*—For taxable years ending on and after December 31, 1955, declarations of estimated tax for the taxable year shall be filed on or before the 15th day of the 9th month of such year by every corporation whose then anticipated income tax liability under section 11, or section 1201(a), or subchapter L of chapter 1 of the Code for the year meets the requirements of section 6016(a). If, however, the requirements necessitating the filing of a declaration are first met after the last day of the 8th month and before the first day of the 12th month of the

taxable year the declaration must be filed on or before the 15th day of the 12th month of the taxable year. If, however, the requirements of section 6016(a) are not met before the first day of the 12th month of the taxable year, no declaration need be filed for such year.

(b) *Place for filing declaration.*—The declaration of estimated tax shall be filed with the district director for the district in which the corporation expects to file its income tax return.

(c) *Amendment of declaration.*—A declaration of estimated tax filed by a corporation prior to the 15th day of the 12th month of the taxable year may be amended, in the manner prescribed in § 1.6016-3, at any time on or before such 15th day. An amended declaration shall be filed with the district director with whom the original declaration was filed.

§ 1.6074-2 TIME FOR FILING DECLARATIONS BY CORPORATIONS IN CASE OF A SHORT TAXABLE YEAR.—(a) *In general.*—In the case of a short taxable year of 9 months or more, where the requirements of section 6016(a) are met before the 1st day of the 9th month of the short taxable year, the declaration shall be filed on or before the 15th day of the 9th month of such short year. In the case of a short taxable year of more than 9 months, where the requirements of section 6016(a) are first met after the last day of the 8th month, but before the 1st day of the last month of the short taxable year, the declaration shall be filed on or before the 15th day of the last month of such short year. See § 1.6016-4, relating to the requirement of a declaration in the case of a short taxable year, and § 1.6154-2, relating to the time for payment of the estimated tax in case of a short taxable year.

(b) *Amendment of declaration.*—A declaration of estimated tax for a short taxable year of more than 9 months filed by a corporation before the 15th day of the last month of the short taxable year may be amended, in the manner prescribed in § 1.6016-3, any time on or before such 15th day.

(c) *Example.*—The application of the provisions of this section may be illustrated by the following example:

*Example.* A corporation which changes from a calendar year basis to a fiscal year basis beginning November 1 will have a short taxable year beginning January 1 and ending October 31. If the requirements of section 6016(a) are met before September 1 (the 1st day of the 9th month) the corporation is required to file its declaration on or before September 15 (the 15th day of the 9th month). However, if the requirements of section 6016(a) are first met after August 31 (the last day of the 8th month) but before October 1 (the 1st day of the last month of the short year) the corporation would be required to file its declaration on or before October 15 (the 15th day of the last month of the short year).

§ 1.6074-3 EXTENSION OF TIME FOR FILING DECLARATIONS BY CORPORATIONS.—(a) *In general.*—District directors are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. An application by a corporation for an extension of time for filing such a declaration shall be addressed to the district director for the district in which the corporation is required

§ 1.6074-1(b)

to file its declaration, and must contain a full recital of the causes for the delay.

(b) *Addition to tax applicable.*—An extension of time granted to a corporation for filing a declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the corporation from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655(c) without regard to such extension.

#### INSTALLMENT PAYMENTS OF ESTIMATED TAX

### § 1.6153 STATUTORY PROVISIONS; INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY INDIVIDUALS.

#### SEC. 6153. INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY INDIVIDUALS.

(a) **GENERAL RULE.**—The amount of estimated tax (as defined in section 6015(c) with respect to which a declaration is required under section 6015 shall be paid as follows:

(1) If the declaration is filed on or before April 15 of the taxable year, the estimated tax shall be paid in four equal installments. The first installment shall be paid at the time of the filing of the declaration, the second and third on June 15 and September 15, respectively, of the taxable year, and the fourth on January 15 of the succeeding taxable year.

(2) If the declaration is filed after April 15 and not after June 15 of the taxable year, and is not required by section 6073(a) to be filed on or before April 15 of the taxable year, the estimated tax shall be paid in three equal installments. The first installment shall be paid at the time of the filing of the declaration, the second on September 15 of the taxable year, and the third on January 15 of the succeeding taxable year.

(3) If the declaration is filed after June 15 and not after September 15 of the taxable year, and is not required by section 6073 (a) to be filed on or before June 15 of the taxable year, the estimated tax shall be paid in two equal installments. The first installment shall be paid at the time of the filing of the declaration, and the second on January 15 of the succeeding taxable year.

(4) If the declaration is filed after September 15 of the taxable year, and is not required by section 6073(a) to be filed on or before September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(5) If the declaration is filed after the time prescribed in section 6073(a) (including cases in which an extension of time for filing the declaration has been granted under section 6081), paragraphs (2), (3), and (4) of this subsection shall not apply, and there shall be paid at the time of such filing all installments of estimated tax which would have been payable on or before such time if the declaration had been filed within the time prescribed in section 6073(a), and the remaining installments shall be paid at the times at which, and in the amounts in which, they would have been payable if the declaration had been so filed.

(b) **FARMERS.**—If an individual referred to in section 6073(b) (relating to income from farming) makes a declaration of estimated tax after September 15 of the taxable year and on or before January 15 of the succeeding taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(c) **AMENDMENTS OF DECLARATION.**—If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease, as the case may be, in the estimated tax by reason of such amendment, and if any amendment is made after September 15 of the taxable year, any increase

in the estimated tax by reason thereof shall be paid at the time of making such amendment.

(d) **APPLICATION TO SHORT TAXABLE YEARS.**—The application of this section to taxable year of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) **FISCAL YEARS.**—In the application of this section to the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

(f) **INSTALLMENTS PAID IN ADVANCE.**—At the election of the individual, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6153-1 **PAYMENT OF ESTIMATED TAX BY INDIVIDUALS.**—(a) *In general.*—(1) The time for payment of the estimated tax by individuals for calendar years shall be as follows:

<i>Date of filing declaration</i>	<i>Dates of payment of estimated tax</i>
(i) On or before April 15.....	In 4 equal installments—one at time of filing declaration, one on or before June 15, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
(ii) After April 15 and before June 16 if not required to be filed on or before April 15.	In 3 equal installments—one at time of filing declaration, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
(iii) After June 15 and before September 16 if not required to be filed on or before June 15.	In 2 equal installments—one at time of filing declaration, and the other on or before January 15 of the succeeding taxable year.
(iv) After September 15 if not required to be filed on or before September 15.	In full at time of filing declaration.

(2) If, for example, due to the nature and amount of his gross income for 1955, the taxpayer is not required to file his declaration as of April 15, but is required to file the declaration on or before June 15, 1955, the case comes within the scope of subdivision (ii) of subparagraph (1) of this paragraph and the estimated tax is payable in 3 equal installments, the 1st on the date of filing, the 2nd on or before September 15, 1955, and the 3rd installment on or before January 15, 1956.

(3) If a declaration is filed after the time prescribed in section 6073(a) (including any extension of time granted for filing the declaration), there shall be paid at such time all installments of the estimated tax which would have been payable on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 6073(a). The remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been timely filed. Thus, for example, B, a single man who makes his return on the calendar year basis, was employed from the beginning of 1955 and for several years prior thereto at an annual salary of \$6,000, thus meeting the requirements of section 6015(a). B filed his declaration for 1955 on September 16, 1955. In such case, B should have filed a declaration on or before April 15, 1955, and at the time of filing his declaration he was delinquent in the payment of three installments of his estimated tax for the taxable year 1955. Hence, upon his filing the declaration on

September 16, 1955, three-fourths of the estimated tax shown thereon must be paid.

(4) In the case of a decedent, payments of estimated tax are not required subsequent to the date of death. See, however, § 1.6015 (b)-1 (c), relating to the making of an amended declaration by a surviving spouse if a joint declaration was made before the death of the decedent.

(5) The payment of any installment of the estimated tax shall be considered payment on account of the tax for such taxable year. Hence, upon the return for such taxable year, the aggregate amount of the payments of estimated tax should be entered as payments to be applied against the tax shown on such return.

(b) *Farmers*.—Special provisions are made with respect to the filing of the declaration and the payment of the tax by an individual whose estimated gross income from farming is at least two-thirds of his total gross income from all sources for the taxable year. As to what constitutes income from farming within the meaning of this paragraph, see § 1.6073-1 (b). The declaration of such an individual may be filed on or before January 15 of the succeeding taxable year in lieu of the time prescribed for individuals generally. Where such an individual makes a declaration of estimated tax after September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(c) *Amendment of declaration*.—If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amendment. If any amendment is made after September 15 of the taxable year, any increase in the estimated tax by reason thereof shall be paid at the time of making the amendment.

(d) *Installments paid in advance*.—At the election of the taxpayer any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6153-2 **FISCAL YEARS**.—In the case of an individual on the fiscal year basis, the dates prescribed for payment of the estimated tax shall be the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of the taxable year and the 15th day of the 1st month of the succeeding taxable year. For example, if an individual having a fiscal year ending on June 30, 1956, first meets the requirements of section 6015 (a) on January 15, 1956, and the declaration is filed on or before March 15, 1956, the estimated tax shall be paid in 2 equal installments, one at the time of filing of such declaration and the other on or before July 15, 1956.

§ 1.6153-3 **SHORT TAXABLE YEARS**.—In the case of a short taxable year of an individual for which a declaration is required to be filed the estimated tax shall be paid in equal installments, one at the time of filing the declaration, one on the 15 day of the 6th month of the taxable year and another on the 15th day of the 9th month of such year unless the short taxable year closed during or prior to such 6th or 9th month, and one on the 15th day of the 1st month of the succeeding taxable year. For example, if the short taxable year is the period of 10 months from January 1, 1955, to October 31, 1955, and the declaration



is required to be filed on or before April 15, 1955, the estimated tax is payable in 4 equal installments, one on the date of filing the declaration, and one each on June 15, September 15, and November 15, 1955. If in such case the declaration is required to be filed after April 15 but on or before June 15, the tax will be payable in 3 equal installments, one on the date of filing the declaration, and one each on September 15, and November 15, 1955. The provisions of § 1.6153-1(a)(3), relating to payment of estimated tax in any case in which the declaration is filed after the time prescribed in section 6073 and §§ 1.6073-1 to 1.6073-4, inclusive, are equally applicable to the payment of the estimated tax for short taxable years.

§ 1.6153-4 EXTENSION OF TIME FOR PAYING THE ESTIMATED TAX.—An extension of time granted an individual under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6073-4 for rules relating to extensions of time for filing declarations of estimated tax by individuals. An application for an extension of time for paying a particular installment of the estimated tax shall be addressed to the district director for the district in which the taxpayer files his declaration, and must contain a full recital of the causes for the delay. Such extension may be for a reasonable period not to exceed 6 months from the date fixed for payment thereof except in the case of a taxpayer who is abroad. Such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654(c) without regard to such extension.

#### § 1.6154 STATUTORY PROVISIONS; INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY CORPORATIONS.

##### SEC. 6154. INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY CORPORATIONS.

(a) AMOUNT OF ESTIMATED INCOME TAX REQUIRED TO BE PAID.—The amount of estimated tax (as defined in section 6016(b)) with respect to which a declaration is required under section 6016 shall be paid as follows:

If the taxable year ends—	The amount required to be paid shall be the following percentage of the estimated tax:
On or after December 31, 1955 and before December 31, 1956__	10
On or after December 31, 1956 and before December 31, 1957__	20
On or after December 31, 1957 and before December 31, 1958__	30
On or after December 31, 1958 and before December 31, 1959__	40
On or after December 31, 1959_____	50

(b) TIME FOR PAYMENT OF INSTALLMENT.—If the declaration is filed on or before the 15th day of the 9th month of the taxable year, the amount determined under subsection (a) shall be paid in two equal installments. The first installment shall be paid on or before the 15th day of the 9th month of the taxable year, and the second installment shall be paid on or before the 15th day of the 12th month of the taxable year. If the declaration is filed after the 15th days of the 9th month of the taxable year, the

amount determined under subsection (a) shall be paid in full on or before the 15th day of the 12th month of the taxable year.

(c) **AMENDMENT OF DECLARATION.**—If any amendment of a declaration is filed, installments payable on the 15th day of the 12th month, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease, as the case may be, in the estimated tax by reason of such amendment.

(d) **APPLICATION TO SHORT TAXABLE YEAR.**—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) **INSTALLMENTS PAID IN ADVANCE.**—At the election of the corporation, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6154-1 **PAYMENT OF ESTIMATED TAX BY CORPORATIONS.**—(a) *Amount required to be paid.*—Every corporation required to file a declaration of estimated tax shall pay the following percentage of its estimated tax:

If the taxable year ends—	The amount required to be paid is the following percentage of the estimated tax:
On or after December 31, 1955 and before December 31, 1956_____	10
On or after December 31, 1956 and before December 31, 1957_____	20
On or after December 31, 1957 and before December 31, 1958_____	30
On or after December 31, 1958 and before December 31, 1959_____	40
On or after December 31, 1959_____	50

(b) *Time for payment.*—(1) In the case of a corporation on the calendar year basis which files its declaration on or before September 15 of the taxable year, the percentage of the estimated tax required to be paid is payable in two equal installments, one at the time of filing the declaration, and the other on or before December 15 of the taxable year. If the corporation files its declaration after September 15 of the taxable year the percentage of the estimated tax required to be paid is payable in full on or before December 15 of the taxable year.

(2) In the case of a corporation whose taxable year is not the calendar year, the dates prescribed for payment of the estimated tax shall be the 15th day of the 9th month and the 15th day of the 12th month of such taxable year. If the corporation files its declaration after the 15th day of such 9th month, the percentage of the estimated tax required to be paid is payable in full on or before the 15th day of such 12th month.

(c) *Amendment of declaration.*—In the case of an amended declaration, filed in accordance with section 6074, the installment payable on the 15th day of the 12th month of the taxable year shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amended declaration. For example, C, a corporation on the calendar year basis filed a declaration on September 15, 1955, reporting an estimated tax in the amount of \$20,000. The first installment of \$1,000 (5% of \$20,000) accompanied the declaration. However, C filed an amended declara-

tion on December 15, 1955, showing an estimated tax of \$30,000. Since C has already paid \$1,000, it must make a payment in the amount of \$2,000 computed as follows:

Required amount of estimated tax which must be paid for calendar year 1955 (10% of \$30,000) .....	\$3,000
Amount paid with original estimate (5% of \$20,000) .....	1,000
Balance to accompany amended declaration .....	\$2,000

Had the amended declaration been filed on December 10, 1955, then only the balance of the first installment (\$500) otherwise due on September 15 would have been required to be paid with the declaration and the installment required to be paid on or before December 15, 1955, would be \$1,500.

(d) *Installments paid in advance.*—A corporation may, at its election, pay any installment of its estimated tax in advance of the due date.

(e) *Credit against income tax.*—Payments of estimated tax shall be considered payments on account of the income tax liability for the taxable year. Hence the amount of estimated tax paid shall be entered on the return as a credit to be applied against the tax shown thereon.

§ 1.6154-2 SHORT TAXABLE YEARS.—(a) *In general.*—In the case of a corporation filing a declaration for a short taxable year the amount of the estimated tax required to be paid shall be paid as follows:

(1) If the short taxable year is a period of more than 9 months and the declaration is required to be filed on or before the 15th day of the 9th month, the amount of the estimated tax required to be paid shall be paid in 2 installments; the 1st on or before the 15th day of the 9th month and the 2nd on or before the 15th day of the last month of the short taxable year.

(2) If the short taxable year is a period of 9 or more months and the declaration is not required to be filed until the 15th day of the last month of the short taxable year, the amount of the estimated tax required to be paid shall be paid in full on or before the 15th day of the last month of the short taxable year.

(b) *Examples.*—The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* If a corporation changes from a calendar year to a fiscal year beginning November 1, 1956, and ending October 31, 1957, a declaration is required on or before September 15, 1956, for the short taxable year January 1, 1956, to October 31, 1956, if such corporation otherwise meets the requirements of section 6016(a) on or before August 31, 1956. In such case the first installment of the estimated tax must be paid with the declaration filed on September 15, 1956. The second installment must be paid on or before October 15, 1956, the 15th day of the last month in the short taxable year.

*Example (2).* If, in the first example, the corporation did not meet the requirements of section 6016(a) until after August 31, 1956, but before October 1, 1956, the declaration would have been due on

October 15, 1956. In such case the amount of the estimated tax required to be paid must be paid in full with the declaration filed on October 15, 1956.

§ 1.6154-3 EXTENSION OF TIME FOR PAYING ESTIMATED TAX.—An extension of time granted a corporation under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6074-3 for rules relating to extensions of time for filing declarations of estimated tax by corporations. An application for an extension of time for paying an installment of the estimated tax shall be addressed to the district director for the district in which the taxpayer files its declaration, and must contain a full recital of the causes for the delay. Any such extension will not relieve the taxpayer from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655(c) without regard to such extension.

#### FAILURE TO PAY ESTIMATED INCOME TAX

### § 1.6654 STATUTORY PROVISIONS; FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX.

#### SEC. 6654. FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX.

(a) ADDITION TO THE TAX.—In the case of any underpayment of estimated tax by an individual, except as provided in subsection (d), there shall be added to the tax under chapter 1 for the taxable year an amount determined at the rate of 6 percent per annum upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c)).

(b) AMOUNT OF UNDERPAYMENT.—For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 70 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax shown on the return for the taxable year or, if no return was filed, 70 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment.

(c) PERIOD OF UNDERPAYMENT.—The period of the underpayment shall run from the date the installment was required to be paid to whichever of the following dates is the earlier—

(1) The 15th day of the fourth month following the close of the taxable year.

(2) With respect to any portion of the underpayment, the date on which such portion is paid. For purposes of this paragraph, a payment of estimated tax on any installment date shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b)(1) for such installment date.

(d) EXCEPTION.—Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds whichever of the following is the lesser—

(1) The amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the least—

(A) The tax shown on the return of the individual for the preceding taxable year, if a return showing a liability for tax was filed by the individual for the preceding taxable year and such preceding year was a taxable year of 12 months, or

(B) An amount equal to the tax computed, at the rates applicable to the taxable year, on the basis of the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on his return for, and the law applicable to, the preceding taxable year, or

(C) An amount equal to 70 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax for the taxable year computed by placing on an annualized basis the taxable income for the months in the taxable year ending before the month in which the installment is required to be paid. For purposes of this subparagraph, the taxable income shall be placed on an annualized basis by—

(i) multiplying by 12 (or, in the case of a taxable year of less than 12 months, the number of months in the taxable year) the taxable income (computed without deduction of personal exemptions) for the months in the taxable year ending before the month in which the installment is required to be paid,

(ii) dividing the resulting amount by the number of months in the taxable year ending before the month in which such installment date falls, and

(iii) deducting from such amount the deductions for personal exemptions allowable for the taxable year (such personal exemptions being determined as of the late date prescribed for payment of the installment); or

(2) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the months in the taxable year ending before the month in which the installment is required to be paid.

(e) APPLICATION OF SECTION IN CASE OF TAX WITHHELD ON WAGES.—For purposes of applying this section—

(1) The estimated tax shall be computed without any reduction for the amount which the individual estimates as his credit under section 31 (relating to tax withheld at sources on wages), and

(2) The amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated, and an equal part of such amount shall be deemed paid on each installment date (determined under section 6153) for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

(f) TAX COMPUTED AFTER APPLICATION OF CREDITS AGAINST TAX.—For purposes of subsections (b) and (d), the term "tax" means the tax imposed by chapter 1 reduced by the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages).

(g) SHORT TAXABLE YEAR.—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(h) APPLICABILITY.—This section shall apply only with respect to taxable years beginning after December 31, 1954; and section 294(d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6654-1 ADDITION TO THE TAX IN THE CASE OF AN INDIVIDUAL.—

(a) *In general.*—(1) Section 6654 imposes an addition to the tax under chapter 1 of the Code in the case of any underpayment of estimated tax by an individual (with certain exceptions described in sec-

§ 1.6654-1(a)(1)

tion 6654(d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of—

(i) 70 percent ( $66\frac{2}{3}$  percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax shown on the return for the taxable year or, if no return was filed, 70 percent ( $66\frac{2}{3}$  percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax for such year, divided by the number of installment dates prescribed for such taxable year, over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determined at the rate of 6 percent per annum upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the fourth month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for the payment of any installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on any installment date, to the extent that it exceeds the amount of the installment determined under subparagraph (1)(i) of this paragraph for such installment date, shall be considered a payment of any previous underpayment.

(3) In determining the amount of the installment paid on or before the last day prescribed for payment thereof, the estimated tax shall be computed without any reduction for the amount which the taxpayer estimates as his credit under section 31 (relating to tax withheld at source on wages), and the amount of such credit shall be deemed a payment of estimated tax. An equal part of the amount of such credit shall be deemed paid on each installment date (determined under section 6153) for the taxable year unless the taxpayer establishes the dates on which all amounts were actually withheld. In the latter case, all amounts withheld shall be considered as payments of estimated tax on the dates such amounts were actually withheld. Under section 31 the entire amount withheld during a calendar year is allowed as a credit against the tax for the taxable year which begins in such calendar year. However, where more than one taxable year begins in any calendar year no portion of the amount withheld during the calendar year will be treated as a payment of estimated tax for any taxable year other than the last taxable year beginning in such calendar year. The rules prescribed in this subparagraph for determining the time as of which the amount withheld shall be deemed paid are applicable even though such amount was withheld during a taxable year preceding that for which the credit is allowed.

(4) The term "tax" when used in subparagraph (1)(i) of this paragraph shall mean the tax imposed by chapter 1 of the Code reduced by all credits allowed by part IV of subchapter A of that chapter except the credit provided by section 31, relating to tax withheld at source on wages. For the disallowance of certain credits

in the case of taxpayers who elect to use the standard deduction or to pay the optional tax imposed by section 3, see section 36.

(b) *Statement relating to underpayment.*—If there has been an underpayment of estimated tax as of any installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6654-2 precludes the assertion of the addition to the tax under section 6654, he should attach to his income tax return for the taxable year a Form 2210 showing the applicability of any exception upon which he relies.

(c) *Examples.*—The method prescribed in paragraph (a) of this section for computing the addition to the tax may be illustrated by the following examples:

*Example (1).* An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of \$40,000. He has paid a total of \$20,000 of estimated tax in four equal installments of \$5,000 on each of the four installment dates prescribed for such year. No other payments were made prior to the date the return was filed. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-quarter of 70 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1)	Amount of tax shown on return.....	\$40,000
(2)	70 percent of item (1) .....	28,000
		<hr/>
(3)	$\frac{1}{4}$ of item (2) .....	\$7,000
(4)	Deduct amount paid on each installment date.....	5,000
		<hr/>
(5)	Amount of underpayment for each installment date (item (3) minus item (4)) .....	\$2,000
(6)	Addition to the tax:	
	1st installment—period 4/15/55 to 4/15/56.....	\$120
	2nd installment—period 6/15/55 to 4/15/56.....	100
	3rd installment—period 9/15/55 to 4/15/56.....	70
	4th installment—period 1/15/56 to 4/15/56.....	30
		<hr/>
	Total .....	\$320

*Example (2).* An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of \$30,000. The requirements of section 6015(a) were first met after April 1 and before June 2, 1955, and a total of \$18,000 of estimated tax was paid in three equal installments of \$6,000 on each of the three installment dates prescribed for such year. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-third of 70 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1)	Amount of tax shown on return.....	\$30,000
(2)	70 percent of item (1) .....	21,000
		<hr/>
(3)	$\frac{1}{3}$ of item (2) .....	\$7,000
(4)	Deduct amount paid on each installment date.....	6,000
		<hr/>
(5)	Amount of underpayment for each installment date (item (3) minus item (4)) .....	\$1,000

## (6) Addition to the tax:

1st installment—period 6/15/55 to 4/15/56.....	\$50
2d installment—period 9/15/55 to 4/15/56.....	35
3d installment—period 1/15/56 to 4/15/56.....	15

Total ..... \$100

§ 1.6654-2 EXCEPTIONS TO IMPOSITION OF THE ADDITION TO THE TAX IN THE CASE OF INDIVIDUALS.—(a) *In general.*—The addition to the tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax, if on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the least of the following amounts—

(1) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were the tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year;

(2) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a tax determined on the basis of the tax rates and the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of an individual required to file a return for such preceding taxable year;

(3) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to 70 percent (66 $\frac{2}{3}$  percent in the case of individuals referred to in section 6073(b), relating to income from farming) of the tax computed by placing on an annual basis the taxable income for the calendar months in the taxable year preceding such date. The taxable income shall be placed on an annual basis by—

(i) Multiplying by 12 (or the number of months in the taxable year if less than 12) the taxable income (computed without the standard deduction and without the deductions for personal exemptions), or the adjusted gross income if the standard deduction is to be used, for such calendar months,

(ii) Dividing the resulting amount by the number of such calendar months, and

(iii) Deducting from such amount the standard deduction, if applicable, and the deductions for personal exemptions (such personal exemptions being determined as of the date prescribed for payment); or

(4) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the calendar months in the taxable year preceding the date prescribed for payment.

In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f), the rules prescribed by § 1.441-2 (b) shall be applicable in determining, for purposes of subparagraph

§ 1.6654-2(a)



(1) of this paragraph, whether a taxable year was a year of 12 months and, for purposes of subparagraphs (3) and (4) of this paragraph, the number of calendar months in a taxable year preceding the date prescribed for payment of an installment of estimated tax. For rule to be applied in determining taxable income for any period described in subparagraphs (3) and (4) of this paragraph in the case of a taxpayer who employs accounting periods (e. g., thirteen 4-week periods or four 13-week periods) none of which terminates with the end of the applicable period described in subparagraph (3) or (4) of this paragraph, see § 1.6655-2(a)(5).

(b) *Meaning of terms.*—As used in this section and § 1.6654-3—

(1) The term “tax” means the tax imposed by chapter 1 of the Code reduced by the credits against tax allowed by part IV of subchapter A of such chapter, other than the credit against tax provided by section 31 (relating to tax withheld on wages), and without reduction for any payments of estimated tax.

(2) The credits against tax allowed by part IV of subchapter A of chapter 1 are—

(i) In the case of the exception described in subparagraph (1) of paragraph (a) of this section, the credits shown on the return for the preceding taxable year.

(ii) In the case of the exception described in subparagraph (2) of paragraph (a) of this section, the credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates or status with respect to personal exemptions, the credits shall be determined by reference to the rates and status applicable to the current taxable year, and

(iii) In the case of the exceptions described in subparagraphs (3) and (4) of paragraph (a) of this section, the credits computed under the law and rates applicable to the current taxable year.

A change in rate may be either a change in the rate of tax, such as a change in the rate of the tax imposed by section 1, or a change in any percentage affecting the computation of the credit, such as a change in the rate of withholding under chapter 3 or a change in the percentage of dividends received specified in section 34(a). The application of the preceding sentence may be illustrated by the following examples:

*Example (1).* Assume the percentage of dividends received which, subject to the limitations in section 34(b), is allowed as a credit against the tax under section 34(a) is changed from 4 to 5 percent. In determining the applicability of the exception described in subparagraph (2) of paragraph (a) of this section to an underpayment of estimated tax for the year in which such percentage changes, the 5 percent rate is applicable in determining the amount of the credit under section 34.

*Example (2).* Assume the rate of tax under section 1 on the first \$2,000 of taxable income is changed from 20 percent to 18 percent. The credit allowed under section 37(a) for retirement income is determined at the rate applicable to the first \$2,000 of taxable income. In determining the applicability of the exception described in sub-

paragraph (2) of paragraph (a) of this section to an underpayment of estimated tax for the year during which such change occurs, the 18 percent rate is applicable in determining the amount of the credit for retirement income under section 37.

(3) The term "return for the preceding taxable year" means the income tax return for such year which is required by section 6012 (a) (1).

(c) *Examples.*—The following examples illustrate the application of the exceptions to the imposition of the addition to the tax for an underpayment of estimated tax, in the case of an individual whose taxable year is the calendar year:

*Example (1).* T, a married man with one child and a dependent parent, files a joint return with his spouse, W, for 1955 on April 15, 1956, showing taxable income of \$44,000 and a tax of \$16,760. T and W had filed a joint declaration of estimated tax on April 15, 1955, showing and estimated tax of \$10,000 which was paid in four equal installments of \$2,500 each on April 15, June 15, and September 15, 1955, and January 15, 1956. The balance of \$6,760 was paid with the return. T and W have an underpayment of estimated tax of \$483 ( $\frac{1}{4}$ th of 70% of \$16,760, less \$2,500) for each installment date. The 1954 calendar year return of T and W showed a liability of \$10,000. Since the total amount of estimated tax paid by each installment date equalled the amount that would have been required to be paid on or before each of such dates if the estimated tax were the tax shown on the return for the preceding year, the exception described in paragraph (a) (1) of this section applies and no addition to the tax will be imposed.

*Example (2).* Assume the same facts as in example (1) except that the joint return of T and W for 1954 showed taxable income of \$32,000 and a tax liability of \$10,400. Assume further that only two personal exemptions under section 151 appeared on the 1954 return. The exception described in paragraph (a) (1) of this section would not apply. However, T and W are entitled to four exemptions under section 151 for 1955. Taxable income for 1954 based on four exemptions, but otherwise on the basis of the facts shown on the 1954 return, would be \$30,800. The tax on such amount in the case of a joint return would be \$9,836. Since the total amount of estimated tax paid by each installment date exceeds the amount which would have been required to be paid on or before each of such dates if the estimated tax were \$9,836, the exception described in paragraph (a) (2) of this section applies and no addition to the tax will be imposed.

*Example (3).* A and B, his spouse, filed a joint return for the calendar year 1955, showing a tax liability of \$10,000, attributable primarily to income received during the last quarter of the year. Their aggregate payments of estimated tax on or before September 15, 1955, total \$1,312.50, representing three installments of \$437.50 paid on each of the first three installment dates prescribed for the taxable year. There was an underpayment on each of these dates since the installment paid, \$437.50, was less than \$1,750 ( $\frac{1}{4}$  of 70 percent of \$10,000). Assume that the exceptions described in paragraph (a) (1) and (2) of this section do not apply. Actual taxable

income for the three months ending March 31, 1955, was \$2,000 and for the five months ending May 31, 1955, was \$4,500. Since the amounts paid by the April 15 and June 15 installment dates, \$437.50 and \$875, respectively, exceeded \$360 and \$819 (90 percent of the tax determined on actual taxable income of \$2,000 and \$4,500, respectively, on the basis of a joint return), the exception described in paragraph (a) (4) of this section applies and no addition to the tax will be imposed for the underpayments on the April 15 and June 15 installment dates. Actual taxable income, assuming A and B did not elect to use the standard deduction, for the eight months ending August 31, 1955, was \$7,000. Since the total amount paid by the September 15 installment date, \$1,312.50, was less than \$1,314 (90 percent of the tax on \$7,000 of taxable income, determined on the basis of a joint return), the exception described in paragraph (a) (4) of this section does not apply to the September 15 installment. However, the exception described in paragraph (a) (3) of this section does apply in accordance with the following computation:

Taxable income for the period ending August 31, 1955 without deduction for personal exemptions) on an annual basis ( $\$8,200 \times 12 \div 8$ ) .....	\$12,300.00
Deduction for two personal exemptions.....	1,200.00
	<hr/>
	\$11,100.00
Tax on \$11,100 (on the basis of a joint return).....	2,486.00
$\frac{3}{4}$ of 70 percent of \$2,486.....	1,305.15
Amount paid by September 15, 1955.....	1,312.50

*Example (4).* Assume the same facts as in example (3) and assume further that adjusted gross income for the eight months ending August 31, 1955, was \$8,700 and the amount of deductions (other than the deduction for personal exemptions) not allowable in determining adjusted gross income aggregate only \$500. If A and B elect, they may use the standard deduction in computing the tax for purposes of the exceptions described in paragraph (a) (3) and (4) of this section. Taxable income, for purposes of the exception described in paragraph (a) (4) of this section would be reduced to \$6,630 with the use of the standard deduction (\$8,700 less \$1,200 for two personal exemptions and \$870 for the standard deduction). The tax thereon is \$1,378.60. Since the amount paid by the September 15 installment date, \$1,312.50, exceeds \$1,180.74 (90 percent of \$1,378.60), the exception described in paragraph (a) (4) of this section applies. The exception described in paragraph (a) (3) of this section also applies in accordance with the following computation:

Adjusted gross income for period ending August 31, 1955.....	\$8,700.00
Adjusted gross income annualized ( $\$8,700 \times 12 \div 8$ ).....	13,050.00
Taxable income annualized (\$13,050 minus \$1,200 for two personal exemptions and \$1,000 for standard deduction).....	10,850.00
Tax on \$10,850 (on basis of joint return).....	2,421.00
$\frac{3}{4}$ of 70 percent of \$2,421.....	1,271.02
Amount paid by September 15, 1955.....	1,312.50

*Example (5).* H was a married individual, 73 years of age, who filed a joint return with his wife, W, for the calendar year 1956. W, who was 70 years of age, had no income during the year. H had

taxable income in the amount of \$7,000 for the eight-month period ending on August 31, 1956, which included \$2,000 of dividend income (after excluding \$50 under section 116) and \$900 of rental income. The \$7,000 figure also reflected a deduction of \$2,400 for personal exemptions ( $\$600 \times 4$ ), since H and W were both over 65 years of age. The application of the exception described in paragraph (a) (3) of this section to an underpayment of estimated tax on the September 15th installment date may be illustrated by the following computation:

Taxable income for the period ending August 31, 1956 (without deduction for personal exemptions) on an annual basis ( $\$9,400 \times 12 \div 8$ )	\$14,100.00
Deduction for personal exemptions	2,400.00
<b>Taxable income on an annual basis</b>	<b>\$11,700.00</b>
Tax (on the basis of a joint return)	2,642.00
Dividends received for 8-month period	\$2,050
Less: Amount excluded from gross income under section 116.	50
<b>Dividends included in gross income</b>	<b>\$2,000</b>
Dividend income annualized ( $\$2,000 \times 12 \div 8$ )	3,000
Dividends received credit under section 34 (4 percent of \$3,000)	120.00
<b>Tax less dividends received credit</b>	<b>\$2,522.00</b>
Retirement income (as defined in section 37(c)) includes:	
Dividend income (to extent included in gross income)	\$2,000
Rental income	900
<b>Total retirement income</b>	<b>\$2,900</b>
Limit on amount of retirement income under section 37(d)	1,200
Retirement income credit under section 37 (20 percent of \$1,200)	240.00
<b>Tax less credits under section 34 and section 37</b>	<b>\$2,282.00</b>
Amount determined under the exception described in paragraph (a) (3) of this section ( $\frac{1}{4}$ of 70 percent of \$2,282)	1,198.05

(d) *Determination of taxable income for installment periods.*—(1) *In general.*—(i) In determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section, there must be an accurate determination of the amount of income and deductions for the calendar months in the taxable year preceding the installment date as of which the determination is made, that is, for the period terminating with the last day of the third, fifth, or eighth month of the taxable year. For example, a taxpayer distributes year-end bonuses to his employees but does not determine the amount of the bonuses until the last month of the taxable year. He may not deduct any portion of such year-end bonuses in determining his taxable income for any installment period other than the final installment period for the taxable year, since deductions are not allowable until paid or accrued, depending on the taxpayer's method of accounting.

(ii) If a taxpayer on an accrual method of accounting wishes to use either of the exceptions described in paragraph (a) (3) and (4) of this section, he must establish the amount of income and deductions for each applicable period. If his income is derived from a business in which the production, purchase, or sale of merchandise is an income-producing factor requiring the use of inventories, he will be unable

to determine accurately the amount of his taxable income for the applicable period unless he can establish, with reasonable accuracy, his cost of goods sold for the applicable installment period. The cost of goods sold for such period shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such installment period is of gross receipts from sales for the entire taxable year.

(2) *Members of partnerships.*—The provisions of this subparagraph shall apply in determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section to an underpayment of estimated tax by a taxpayer who is a member of a partnership.

(i) There shall be taken into account—

(a) The partner's distributive share of partnership items set forth under section 702,

(b) The amount of any guaranteed payments under section 707(c), and

(c) Gains or losses on partnership distributions which are treated as gains or losses on sales of property.

In determining a partner's taxable income for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in section 702 for any partnership taxable year ending with or within his taxable year to the extent that such items are attributable to months in such partnership taxable year which precede the month in which the installment date falls. In addition, a partner shall include in his taxable income for the months in his taxable year which precede the month in which the installment date falls guaranteed payments from the partnership to the extent that such guaranteed payments are includible in his taxable income for such months. See section 706(a), section 707(c) and § 1.707-1(c).

(ii) The provisions of subdivision (i) (a) and (b) of this subparagraph may be illustrated by the following examples:

*Example (1).* A, whose taxable year is the calendar year, is a member of a partnership whose taxable year ends on January 31st. A must take into account, in determining his taxable income for the installment due on April 15, 1955, all of his distributive share of partnership items described in section 702 and the amount of any guaranteed payments made to him which were deductible by the partnership in the partnership taxable year beginning on February 1, 1954, and ending on January 31, 1955.

*Example (2).* Assume that the taxable year of the partnership of which A, a calendar year taxpayer, is a member ends on June 30th. A must take into account in the determination of his taxable income for the installment due on April 15, 1955, his distributive share of partnership items described in section 702 for the period July 1, 1954, through March 31, 1955; for the installment due on June 15, 1955, he must take into account such amounts for the period July 1, 1954, through May 31, 1955; and for the installment due on September 15, 1955, he must take into account such amounts for the entire partnership taxable year of July 1, 1954, through June 30, 1955 (the date on which the partnership taxable year ends).

(3) *Beneficiaries of estates and trusts.*—In determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section as of any installment date, the beneficiary of an estate or trust must take into account his distributable share of income from the estate or trust for the applicable period (whether or not actually distributed) if the trust or estate is required to distribute income to him currently. If the estate or trust is not required to distribute income currently, only the amounts actually distributed to the beneficiary during such period must be taken into account. If the taxable year of the beneficiary and the taxable year of the estate or trust are different, there shall be taken into account the beneficiary's distributable share of income, or the amount actually distributed to him as the case may be, during the months in the taxable year of the estate or trust ending within the taxable year of the beneficiary which precede the month in which the installment date falls. See subparagraph (2) of this paragraph for examples of a similar rule which is applied when a partner and the partnership of which he is a member have different taxable years.

(e) *Special rule in case of change from joint return or separate return for the preceding taxable year.*—(1) *Joint return to separate return.*—In determining the applicability of the exceptions described in paragraph (a) (1) and (2) of this section to an underpayment of estimated tax, a taxpayer filing a separate return who participated in the filing of a joint return for the preceding taxable year, shall be subject to the following rule. The tax—

(i) Shown on the return for the preceding taxable year, or

(ii) Based on the tax rates and personal exemptions for the taxable year but otherwise determined on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year,

shall be that portion of the tax which bears the same ratio to the whole of the tax as the amount of tax for which the taxpayer would have been liable bears to the sum of the taxes for which the taxpayer and his spouse would have been liable had each spouse filed a separate return for the preceding taxable year.

(2) *Example.*—The rule in subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* H and W filed a joint return for the calendar year 1955 showing taxable income of \$20,000 and a tax of \$5,280. Of the \$20,000 taxable income, \$18,000 was attributable to H, and \$2,000 was attributable to W. H and W filed separate returns for 1956. The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a) (1) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H for 1955.....	\$18,000	
Tax on \$18,000 (on basis of separate return).....		\$6,200
Taxable income of W for 1955.....	2,000	
Tax on \$2,000 (on basis of separate return).....		400
		<hr/> \$6,600

Aggregate tax of H and W (on basis of separate returns).....

Portion of 1955 tax shown on joint return attributable to H

6200

6600 × 5280) .....

4,900

(3) *Separate return to joint return.*—In the case of a taxpayer who participates in the filing of a joint return for the taxable year with respect to which there is an underpayment of estimated tax and who filed a separate return for the preceding taxable year—

(i) The tax shown on the return for the preceding taxable year, for the purposes of determining the applicability of the exception described in paragraph (a) (1) of this section, shall be the sum of both the tax shown on the return of the taxpayer and the tax shown on the return of the taxpayer's spouse for such preceding year, and

(ii) The facts shown on both the taxpayer's return and the return of his spouse for the preceding taxable year shall be taken into account for purposes of determining the applicability of the exception described in paragraph (a) (2) of this section.

(4) *Example.*—The rules described in subparagraph (3) of this paragraph may be illustrated by the following example:

*Example.* H and W filed separate income tax returns for the calendar year 1954 showing tax liabilities of \$2,640 and \$350, respectively. In 1955 they married and participated in the filing of a joint return for that year. Thus, for the purpose of determining the applicability of the exceptions described in paragraph (a) (1) and (2) of this section to an underpayment of estimated tax for the year 1955, the tax shown on the return for the preceding taxable year is \$2,990 (\$2,640 plus \$350).

§ 1.6654-3 SHORT TAXABLE YEARS OF INDIVIDUALS.—(a) *In general.*—The provisions of section 6654, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See § 1.6015(g)-1 for requirement of declaration for short taxable year.)

(b) *Rules as to application of section 6654(d).*—(1) In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax—

(i) Shown on the return for the preceding taxable year (for purposes of section 6654(d) (1) (A)), or

(ii) Based on the personal exemptions and rates for the current taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year (for purposes of section 6654(d) (1) (B)), the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12.

(2) If the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in annualizing the income for the months in the taxable year preceding an installment date, for purposes of section 6654(d) (1) (C), the personal exemptions allowed as deductions under section 151 shall be reduced to the same extent that they are reduced under section 443(c) in computing the tax for a short taxable year.

(3) If "the preceding taxable year" referred to in section 6654(d) (1) (B) was a short taxable year, the tax computed on the

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basis of the facts shown on the return for such preceding year, for purposes of determining the applicability of the exception described in section 6654(d) (1) (B), shall be the tax computed on the annual basis in the manner described in section 443(b) (1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates or the taxpayer's status with respect to personal exemptions for the taxable year with respect to which the underpayment occurs differ from such rates or status applicable to the preceding taxable year, the tax determined in accordance with the preceding sentence shall be recomputed to reflect the rates and status applicable to the year with respect to which the underpayment occurs.

§ 1.6654-4 APPLICABILITY.—Section 6654 is applicable only with respect to taxable years beginning after December 31, 1954. Section 294(d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6655 STATUTORY PROVISIONS; FAILURE BY CORPORATION TO PAY ESTIMATED INCOME TAX.

SEC. 6655. FAILURE BY CORPORATION TO PAY ESTIMATED INCOME TAX.

(a) ADDITION TO THE TAX.—In case of any underpayment of estimated tax by a corporation, except as provided in subsection (d), there shall be added to the tax under chapter 1 for the taxable year an amount determined at the rate of 6 percent per annum upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c)).

(b) AMOUNT OF UNDERPAYMENT.—For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 70 percent of the tax shown on the return for the taxable year or, if no return was filed, 70 percent of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for payment.

(c) PERIOD OF UNDERPAYMENT.—The period of the underpayment shall run from the date the installment was required to be paid to whichever of the following dates is the earlier—

(1) The 15th day of the third month following the close of the taxable year.

(2) With respect to any portion of the underpayment, the date on which such portion is paid. For purposes of this paragraph, a payment of estimated tax on the 15th day of the 12th month shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b) (1) for the 15th day of the 12th month.

(d) EXCEPTION.—Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the lesser—

(1) The tax shown on the return of the corporation for the preceding taxable year reduced by \$100,000, if a return showing a liability for tax was filed by the corporation for the preceding taxable year and such preceding year was a taxable year of 12 months.

(2) An amount equal to the tax computed at the rates applicable to the taxable year but otherwise on the basis of the facts shown on the



return of the corporation for, and the law applicable to, the preceding taxable year.

(3) (A) An amount equal to 70 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income:

(i) for the first 6 months or for the first 8 months of the taxable year, in the case of the installment required to be paid in the ninth month, and

(ii) for the first 9 months or for the first 11 months of the taxable year, in the case of the installment required to be paid in the twelfth month.

(B) For purposes of this paragraph, the taxable income shall be placed on an annualized basis by—

(i) multiplying by 12 the taxable income referred to in subparagraph (A), and

(ii) dividing the resulting amount by the number of months in the taxable year (6 or 8, or 9 or 11, as the case may be) referred to in subparagraph (A).

(e) DEFINITION OF TAX.—For purposes of subsections (b), (d) (2), and

(d) (3), the term “tax” means the excess of—

(1) the tax imposed by section 11 or 1201(a), or subchapter L of chapter 1, whichever is applicable, over

(2) the sum of—

(A) \$100,000, and

(B) the credits against tax provided in part IV of subchapter A of chapter 1.

(f) SHORT TAXABLE YEAR.—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

#### § 1.6655-1 ADDITION TO THE TAX IN THE CASE OF A CORPORATION.—

(a) *In general.*—(1) Section 6655 imposes an addition to the tax under chapter 1 of the Code in the case of any underpayment of estimated tax by a corporation (with certain exceptions described in section 6655(d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of—

(i) 70 percent of the tax shown on the return for the taxable year or, if no return was filed, 70 percent of the tax for such year, multiplied by the percentage of the estimated tax for the taxable year which is required to be paid, and divided by the number of installment dates prescribed for such taxable year, over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determined at the rate of 6 percent per annum upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the third month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for the payment of either installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on the 15th day of the last month of the taxable year, to the extent that it exceeds the amount of the installment determined under subparagraph (1)(i) of this paragraph for such date, shall be considered a payment of the previous underpayment, if any.

(3) The term “tax” as used in subparagraph (1)(i) of this para-

graph means the excess of the tax imposed by section 11 or section 1201(a), or subchapter L of chapter 1 of the Code, whichever is applicable, over the sum of \$100,000 and the credits against the provided by sections 32 and 33.

(4) For special rules relating to the determination of the amount of the underpayment in the case of a corporation whose income is included in a consolidated return, see § 1.1502-49.

(b) *Statement relating to underpayment.*—If there has been an underpayment of estimated tax as of the installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6655-2 precludes the assertion of the addition to the tax under section 6655, it should attach to its income tax return for the taxable year a Form 2220 showing the applicability of any exception upon which the taxpayer relies.

(c) *Example.*—The method prescribed in paragraph (a) of computing the addition to the tax may be illustrated by the following example:

*Example.* A corporation using the calendar year basis reported on its declaration for 1955, estimated tax in the amount of \$50,000. It made payments of \$2,500 each on September 15, 1955, and December 15, 1955. On March 15, 1956, it filed its final income tax return showing a tax liability of \$200,000. Since the amount of each of the two installments paid by the last date prescribed for payment thereof was less than 5 percent of 70 percent of the tax shown on the return, the addition to the tax under section 6655(a) is applicable and is computed as follows:

(1)	Tax as defined in paragraph (a) of this section (\$200,000—\$100,000 (no credits allowable under sections 32 and 33))....	\$100,000
(2)	70% of item (1).....	70,000
(3)	Amount of estimated tax required to be paid on each installment date (5% of \$70,000).....	3,500
(4)	Deduct amount paid on each installment date.....	2,500
(5)	Amount of underpayment for each installment date (item (3) minus item (4)) .....	\$1,000
(6)	Addition to the tax:	
	First installment—period 9/15/55 to 3/15/56.....	\$30
	Second installment—period 12/15/55 to 3/15/56.....	15
	Total .....	\$45

§ 1.6655-2 EXCEPTIONS TO IMPOSITION OF THE ADDITION TO THE TAX IN THE CASE OF CORPORATIONS.—(a) *In general.*—The addition to the tax under section 6655 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were the least of the following amounts—

(1) The tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax and filed for such year;

(2) An amount equal to a tax determined on the basis of the tax rates for the taxable year but otherwise on the basis of the facts

shown on the return for the preceding taxable year and the law applicable to such year, in the case of a corporation required to file a return for such preceding taxable year; or

(3) An amount equal to 70 percent of the tax determined by placing on an annual basis the taxable income for either the first 6 months or the first 8 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid by the 15th day of the 9th month, or for either the first 9 months or the first 11 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid by the 15th day of the 12th month. The taxable income so determined shall be placed on an annual basis by—

(i) Multiplying it by 12, and

(ii) Dividing the resulting amount by the number of months in the taxable year for which the taxable income was so determined.

(4) In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441 (f), the rules prescribed by § 1.441-2(b) shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and in determining, for purposes of subparagraph (3) of this paragraph, the commencement of the 6- or 8-month period or the 9- or 11-month period, whichever is applicable. For example, if a taxable year begins on December 26, 1956, taxable income for the first 6 months of such year, for purposes of subparagraph (3) of this paragraph, shall be taxable income for the period beginning on December 26, 1956, and ending on June 30, 1957, since such taxable year is deemed to commence on January 1, 1957, under section 441(f).

(5) If the end of any accounting period employed by the taxpayer (e. g., any of either thirteen 4-week periods or four 13-week periods) does not correspond to the termination date of the applicable 6- or 8-month or 9- or 11-month period, taxable income shall be determined from the beginning of the taxable year to the close of the accounting period ending immediately before the termination date of the applicable 6- or 8-month or 9- or 11-month period and to the close of the accounting period within which such termination date falls. There shall be determined that portion of the difference between the two amounts of taxable income so determined which bears the same ratio to the total difference between such amounts as the number of days from the close of the first such accounting period to the close of such applicable 6- or 8-month or 9- or 11-month period bears to the total number of days between the termination dates of such two accounting periods. The portion of the difference between such amounts so determined shall then be added to (or subtracted from) taxable income determined to the close of the first such accounting period to determine taxable income for such applicable 6- or 8-month or 9- or 11-month period. For example, a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441 (f) has a taxable year beginning on December 26, 1956, and thirteen 4-week accounting periods are employed in determining taxable income. Taxable income from December 26, 1956, to the close of the 4-week accounting period ending on June 11, 1957, is \$200,000, and taxable income from December 26, 1956, to the close of the 4-week accounting period ending on

July 9, 1957, is \$228,000. Taxable income for the 6-month period ending on June 30, 1957, is \$219,000 ( $\$200,000 + (19 \times 28,000 \div 28)$ ).

(b) *Meaning of terms.*—(1) For the purpose of the exceptions described in paragraph (a) of this section, the term “tax” means the excess of the tax imposed by section 11 or 1201 (a), or subchapter L of chapter 1 of the Code, whichever is applicable, over the sum of \$100,000 plus the credits against the tax allowed by sections 32 and 33.

(2) The credits against the tax allowed by sections 32 and 33 are—

(i) In the case of the exception described in paragraph (a) (1) of this section, such credits shown on the return for the preceding taxable year,

(ii) In the case of the exception described in paragraph (a) (2) of this section, such credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates, the credits shall be determined by reference to the rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a)

(3) of this section, such credits computed under the law and rates applicable to the current taxable year.

The provisions of subdivision (ii) of this subparagraph may be illustrated by the following example:

*Example.* Assume that during the taxable year within which the normal tax rate in section 11 changes from 30 percent to 25 percent, corporation X has an underpayment of estimated tax. One-fourth of the taxable income of corporation X for the taxable year preceding that in which such underpayment occurs was from sources within foreign country Y. The return of corporation X for such preceding year shows taxable income of \$325,000 and a tax, without regard to any credits, of \$163,500. The credit allowed by section 33 on account of taxes paid to foreign country Y may not exceed one-fourth of such amount, or \$40,875, under section 904. The tax for the preceding year, computed by using the rates applicable to the year during which the underpayment occurs, would be reduced to \$147,250 and the limitation under section 904 on the credit allowed under section 33 for taxes paid to foreign country Y would be reduced to \$36,812.50, for purposes of determining the applicability of the exception described in paragraph (a) (2) of this section. Therefore, the exception described in paragraph (a) (2) of this section will be applicable if, on or before the date prescribed for such payment, the total amount paid by corporation X equals or exceeds the amount which would have been required to be paid by such date if the estimated tax were \$10,437.50 ( $\$147,250$  less  $(\$100,000 \div \$36,812.50)$ ).

(3) For the purpose of the exceptions described in paragraph (a) (1) and (2) of this section, the term “return for the preceding taxable year” means the income tax return for such year which is required by section 6012 (a) (2).

(c) *Examples.*—The application of the exceptions to the imposition of the addition to tax may be illustrated by examples employing the following statement of facts:

X, a corporation with a taxable year ending on March 31, filed a declaration on December 15, 1955, showing an estimated tax of

\$35,500 for its taxable year ending March 31, 1956. The first installment of \$1,775 was paid with the filing of the declaration and the second installment in the same amount was paid on March 15, 1956. X reported a tax liability of \$154,300 on its return due June 15, 1956. There was an underpayment of estimated tax in the amount of \$125.50 on each installment date determined as follows:

(1) Tax as defined in paragraph (b) of this section (\$154,300—\$100,000) .....	\$54,300.00
(2) 70 percent of item (1) .....	38,010.00
(3) 5 percent of item (2) .....	1,900.50
(4) Deduct amount paid on each installment date .....	1,775.00
(5) Amount of underpayment at each installment date (item (3) minus item (4)) .....	\$125.50

The application of each exception described in paragraph (a) of this section is determined as follows:

(1) Assume X reported a liability of \$163,500 on its return for the taxable year ending March 31, 1955. If the estimated tax were \$163,500 reduced by \$100,000, or \$63,500, the amount which would have been required to be paid on or before each installment date would be 5 percent of \$63,500, or \$3,175. Since this amount exceeds the amount actually paid on each installment date (\$1,775), the exception described in paragraph (a) (1) of this section does not apply.

(2) Since the corporation tax rates under section 11 are the same for the taxable years ending on March 31, 1955, and March 31, 1956, the amount of tax determined under paragraph (a) (2) of this section and the amount required to be paid on each installment date to qualify under the exception described therein are the same as the corresponding amounts determined under paragraph (a) (1) of this section. Accordingly, the exception described in paragraph (a) (2) of this section does not apply.

(3) X determined that its taxable income for the first 6 months and the first 8 months of the taxable year ended March 31, 1956, was \$180,000 and \$200,000, respectively, and that its taxable income for the first 9 months and the first 11 months was \$264,000 and \$319,000, respectively. The income for each period is annualized as follows:

$$\begin{aligned} \$180,000 \times 12 \div 6 &= \$360,000 \\ \$200,000 \times 12 \div 8 &= \$300,000 \\ \$264,000 \times 12 \div 9 &= \$352,000 \\ \$319,000 \times 12 \div 11 &= \$348,000 \end{aligned}$$

To determine whether the installment payment made on December 15, 1955, equals or exceeds the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for either the 6 or 8-month period, the following computation is necessary:

	6 Months	8 Months
(1) Annualized income .....	\$360,000.00	\$300,000.00
(2) Tax on item (1) reduced by \$100,000 .....	63,700.00	50,500.00
(3) 70% of item (2) .....	44,590.00	35,350.00
(4) 5% of item (3) .....	2,229.50	1,767.50

Since the amount actually paid on December 15, 1955, \$1,775, exceeds the amount which would have been required to be paid on such date

(\$1,767.50) if the estimated tax were 70 percent of the tax determined by placing on an annualized basis the taxable income for the first 8 months of the taxable year, the exception described in paragraph (a) (3) of this section applies and no addition to tax will be imposed for the underpayment of the installment paid on December 15, 1955. A similar computation must be made with respect to the annualized income for the 9 and 11-month periods to determine whether or not the addition to the tax will be imposed with respect to the underpayment of the March 15, 1956, installment. The computation follows:

	9 Months	11 Months
(1) Annualized income .....	\$352,000.00	\$348,000.00
(2) Tax on item (1) reduced by \$100,000.....	59,940.00	58,060.00
(3) 70% of item (2).....	41,958.00	40,642.00
(4) 5% of item (3).....	2,097.90	2,032.10

Since the amount of the installment paid on March 15, 1956, \$1,775, does not equal or exceed the amount which would have been required to be paid on such date if the estimated tax were 70 percent of the tax determined by placing on an annual basis the taxable income for either the 9- or 11-month period, the addition to the tax with respect to the underpayment of the March 15, 1956, installment must be imposed.

(d) *Determination of taxable income for portion of taxable year.*—In determining the applicability of the exception described in paragraph (a) (3) of this section, there must be an accurate determination of the amount of income and deductions for the appropriation period, that is, for the first six, eight, nine, or eleven months of the taxable year. See § 1.6654-2 (d) (1) for a description of a similar requirement with respect to individuals.

### § 1.6655-3 SHORT TAXABLE YEARS IN THE CASE OF CORPORATIONS.—

(a) *In general.*—The provisions of section 6655, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See § 1.6016-4 for requirements of declaration for short taxable year.)

(b) *Rules as to application of section 6655 (d).*—In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax—

(1) Shown on the return for the preceding taxable year (for purposes of section 6655(d) (1)) ;

(2) Based on the current year's rates but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year (for purposes of section 6655(d) (2)) ; or

(3) Computed by placing taxable income for a portion of the current year on an annual basis under section 6655(d) (3) ; the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12. The application of the exception provided in section 6655(d) (3) shall

be determined as if the estimated tax were 70 percent of the tax so reduced.

(c) *Preceding taxable year a short taxable year.*—If “the preceding taxable year” referred to in section 6655(d)(2) was a short taxable year, the tax computed on the basis of the facts shown on the return for such preceding year, for purposes of determining the applicability of the exception described in section 6655(d)(2), shall be the tax computed on the annual basis in the manner described in section 443(b)(1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates for the taxable year with respect to which the underpayment occurs differ from the rates applicable to the preceding taxable year, the tax determined in accordance with the preceding sentence shall be recomputed using the rates applicable to the year with respect to which the underpayment occurs.

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